No.___

IN THE
SUPREME COURT OF THE UNITED STATES

October Term, 1993

MADISON LIBRARY, INC., UNIVERSAL PUBLISHING RESOURCES, LTD., GEOFFREY TOWNSEND, LTD., BARRISTER ASSOCIATES, PARLIAMENT SECURITIES CORP., PAUL BELLOFF AND ROBERT GOLD,

Petitioners,

v.

UNITED STATES OF AMERICA,

Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

PETITION FOR WRIT OF CERTIORARI

Jules Ritholz
KOSTELANETZ RITHOLZ
TIGUE & FINK
80 Pine Street
New York, New York 10005
(212) 422-4030
Counsel for Petitioners

PACKARD PRESS / LEGAL DIVISION, 1617 JFK BOULEVARD, PHILA., PA. 19103 (215) 563-9000

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QUESTIONS PRESENTED

1. Whether the United States Court of Appeals for the Second Circuit erred when it held, as a matter of law, that arm's length bargaining does not exist when a party to a transaction considers favorable tax consequences, as well as other business considerations, on entering into a transaction.

2. Whether an investment promoter may be found liable for a penalty under I.R.C. Section 6700 for gross valuation overstatements based on *post hoc*, subjective appraisal evidence, despite uncontradicted testimony that the allegedly overvalued properties were purchased in arm's length transactions between unrelated parties.

PARTIES TO THE PROCEEDING

All the parties to the proceeding in the United States Court of Appeals for the Second Circuit were Madison Library, Inc., Universal Publishing Resources, Ltd., Geoffrey Townsend, Ltd., Barrister Associates, Paul Belloff, Parliament Securities Corp. and Robert Gold. All of those parties are interested in this proceeding.[1]

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[1]Petitioner Universal Publishing Resources, Ltd. is a wholly-owned subsidiary of Petitioner Geoffrey Townsend, Ltd., which is a wholly-owned subsidiary of Petitioner Madison Library, Inc. Petitioner Madison Library, Inc. is a wholly-owned subsidiary of Hamilton Management Corp., a closely held corporation with no corporate parents. Petitioner Parliament Securities Corp. is a closely-held corporation with no corporate parents or subsidiaries.

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MADISON LIBRARY, INC., UNIVERSAL PUBLISHING RESOURCES, LTD., GEOFFREY TOWNSEND, LTD., BARRISTER ASSOCIATES, PARLIAMENT SECURITIES CORP., PAUL BELLOFF AND ROBERT GOLD,

Petitioners,

v.

UNITED STATES OF AMERICA,

Respondent.

PETITION FOR WRIT OF CERTIORARI

Petitioners Madison Library, Inc. ("Madison"), Universal Publishing Resources, Ltd. ("Universal") and Geoffrey Townsend, Ltd. ("Townsend"), Barrister Associates ("Barrister"), Parliament Securities Corp. ("Parliament"), Paul Belloff and Robert Gold (collectively "Petitioners"), respectfully request that a writ of certiorari be issued to review a decision of the United States Court of Appeals for the Second Circuit, entered on March 22, 1993. That decision affirmed the judgment of the United States District Court for the Eastern District of New York, entered following a trial by jury finding Petitioners liable to pay a penalty pursuant to I.R.C. Section 6700.

OPINIONS BELOW

A copy of the opinion of the United States Court of Appeals for the Second Circuit, entered on March 22, 1993, and reported at 989 F.2d 1290 (2d Cir. 1993), is annexed hereto as an appendix. Also annexed as an appendix is a copy of the Mandate issued June 7, 1993. A copy of the

order of the United States Court of Appeals for the Second Circuit, dated May 20, 1993, which denied Petitioners' petition for a rehearing and suggestion for rehearing in banc is also annexed as an appendix. Also annexed as an appendix is the judgment of the district court, entered after a jury trial, on June 10, 1991. Also annexed as an appendix are the orders of the United States District Court, Eastern District of New York, dated September 19, 1991 and September 30, 1991, denying Petitioners' motions for judgment notwithstanding the verdict or a new trial.

JURISDICTION

The decision of the United States Court of Appeals for the Second Circuit, of which review is sought, was entered on March 22, 1993. That decision affirmed the decision of the United States District Court for the Eastern District of New York, entered following a trial by jury, which found Petitioners liable to pay a penalty pursuant to I.R.C. Section 6700. A petition for rehearing and suggestion for rehearing in banc was denied on May 20, 1993. Jurisdiction to review the judgment in question by certiorari is conferred by 28 U.S.C. Section 1254(1).

STATUTORY PROVISIONS INVOLVED

Title 26 U.S.C. Section 38(a); Title 26 U.S.C. Section 46(a)(2)(A); Title 26 U.S.C. Section 46(c)(1); Title 26 U.S.C. Section 48(a)(1)(A); Title 26 U.S.C. Section 48(d); Title 26 U.S.C. Section 465(b)(2); Title 26 U.S.C. Section 1012; Title 26 U.S.C. Section 6700; Title 26 U.S.C. Section 6703; Rules 401 and 702 of the Federal Rules of Evidence.

STATEMENT OF THE CASE

A. INTRODUCTION.

In 1982 and 1983, Petitioners Townsend and Universal, respectively, purchased certain properties, including films, plates and other materials (the "Properties") used in the manufacture of books and computer software (the "Works"). All of the Properties were purchased from unrelated publishers in arm's length transactions. At the time of the purchases by Townsend and Universal, the Works had already been scheduled for publication and distribution by the publishers in the normal course of business in the hopes of generating profits; thus, the Works would have been published whether or not Universal or Townsend purchased them.

Townsend or Universal purchased each Property for a price represented by a small cash down payment and a twelve-year promissory obligation. The promissory obligation (frequently referred to at trial as a "note," although there was no separate promissory note) bore simple interest at nine per cent per annum. The obligation to amortize the debt before the end of the term depended on the sales of each Work; after twelve years a balloon payment was required for any remaining unpaid sums. As books sold, the publisher received all or most of Townsend's or Universal's proceeds of sale on the initial printing, and a somewhat smaller percentage of their proceeds thereafter, until all principal and interest were paid. The promissory obligation was recourse to Townsend or Universal, and was secured by a chattel mortgage on the Property.

The Properties purchased by Universal and Townsend were leased, in groups of approximately forty, to a number of limited partnerships (the "Partnerships"). Petitioner Barrister, a general partnership, was the general partner of all but two of the Partnerships; Barrister's partners, in turn, were Petitioners Paul Belloff and Robert Gold. The leases with the Partnerships were for eight-year terms. The Partnerships' rent payments had a "fixed" component and a "variable" component based on the number of copies of the Work sold. The Partnerships engaged affiliates of the selling publishers to print, bind, distribute and promote the Works. They were required by contract to use their best efforts to obtain as wide a distribution as possible and to furnish an annual marketing plan for the Works. Their fees were based solely upon the number of copies of each Work sold.

During 1982 and 1983, when Townsend and Universal negotiated the purchases of the Properties, the Internal Revenue Code allowed a tax credit for acquisition of certain types of tangible property, such as the Properties at issue here. I.R.C. Sections 38(a), 46(a)(2)(A), 46(c)(1), 48(a)(1)(A). The amount of the credit was based on the cost of the property. I.R.C. Sections 46(c)(1), 1012. Universal and Townsend, pursuant to Section 48(d) of the Internal Revenue Code, elected to pass through to the Partnerships the investment tax credits that would have been available on the purchase of the Properties.

In June 1986 the Internal Revenue Service ("I.R.S.") assessed penalties against the Petitioners and others pursuant to I.R.C. Section 6700. Petitioners paid fifteen percent of the penalties asserted, staying further collection action, I.R.C. Section 6703(c)(1), and commenced

actions for refunds of the amounts paid.[2] Although Petitioners were technically the plaintiffs in this action, the government had the burden of proof. I.R.C. Section 6703(a). In the Second Circuit, the standard of proof is clear and convincing evidence. *United States v. Philatelic Leasing, Ltd.*, 794 F.2d 781, 785 (2d Cir. 1986), *aff'g*, 601 F. Supp. 1554, 1567 (S.D.N.Y. 1985).

At trial, the government attempted to prove that Petitioners were liable for a penalty under I.R.C. Section 6700 of the Internal Revenue Code of 1954 for making gross valuation overstatements with regard to the Properties.[3] The statute defines "gross valuation overstatement" as a statement as to the value of property or services if:

> (A) The value so stated exceeds 200 percent of the amount determined to be the correct valuation, and
>
> (B) the value of such property or services is directly related to the amount of any deduction or credit allowable under chapter 1 [of the Code] to any participant.

Section 6700(b)(1).

Petitioners contended at trial that there was no valuation overstatement because the Properties were purchased in arm's length transactions between voluntary, knowledgable buyers and sellers, fixing the Properties' purchase prices as their fair market values. *See United States v. Cartwright*, 411 U.S. 546, 533 (1973). Introducing no evidence

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[2]Petitioners Barrister, Parliament, Paul Belloff, and Robert Gold filed suit in the United States District Court for the Eastern District of New York. Petitioners Madison, Townsend and Universal commenced actions in the United States District Court for the District of Nevada, where they were incorporated. The Nevada actions were transferred to the Eastern District of New York by the Judicial Panel on Multidistrict Litigation, and were later consolidated for trial in the Eastern District of New York.

[3]The government also sought to prove that in violation of Section 6700, the Petitioners issued false or fraudulent statements with respect to the tax benefits to be realized by those who purchased an interest in one of the partnerships. The jury so found. This jury finding was challenged on appeal. In affirming the district court decision, the Second Circuit Court of Appeals affirmed the finding of gross valuation overstatements and, as such, did not reach the jury's finding regarding false or fraudulent statements. Whether the jury properly found that there were false or fraudulent statements, therefore, is not at issue in this Petition.

of collusion between the buyer and seller, and relying instead on *post hoc* appraisals grounded in the appraisers' subjective views of the Works, the government contended that those prices were intentionally inflated without regard to business considerations to increase basis for tax purposes. This dispute is at the heart of this proceeding.

B. EVIDENCE OF THE NEGOTIATIONS INTRODUCED AT TRIAL.[4]

1. The Evidence Introduced by the Petitioners.

At trial, Petitioners introduced evidence that the purchase prices for the Properties were negotiated in arm's length bargaining between unrelated parties, with both sides seeking their best economic advantage.

Some publishers, such as Citadel and Stewart Tabori & Chang, furnished Townsend and Universal with titles, synopses, information on the authors, initial print numbers, cover price, and estimates of additional printings. The price of each property was then separately negotiated, usually between Irving Cohen, then the president of Townsend and Universal, and a principal of the publisher. (A98-102.) However, for some publishers with whom Mr. Cohen had previously done business and from whom many Properties were purchased, formulas were negotiated from which the purchase prices were derived.

Richard Gallen, for example, who represented his own company and a number of other publishers in these negotiations (A76-77), testified at trial that the purchase prices were the "product of negotiations that had taken place before any single book was purchased. . .." (A81.) Mr. Gallen negotiated purchase prices that provided the publisher the equivalent of almost all of the revenues from the first printing, after deducting the national distributers' fees, and sixty percent of such revenues for the next seven printings. For each Property, the publisher would furnish Mr. Cohen with the number of books that would be printed initially and the cover price of each book. From these two figures, Mr. Cohen or his delegate would compute purchase prices based on the negotiated formula. (A91-95.) Mr. Cohen would then make an offer commensurate with that calculation, or, at times, would attempt to negotiate a somewhat lower number. (A95.)

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[4]The portions of the trial testimony and trial exhibits cited herein are attached to this Petition as appendices H & I. Citations to particular pages of the appendicies are made thus: (A____).

Mr. Gallen testified that his negotiations with Mr. Cohen were conducted at arm's length, and that Mr. Cohen "vigorously" sought the best possible economic deal for his side. (A78-80.) After Mr. Cohen had negotiated a more favorable purchase price formula with another publisher, he asked Mr. Gallen to renegotiate. Mr. Gallen refused. (A97.)

Price, Stern and Sloan, publisher of juvenile and activity books, inititally demanded a price equivalent to an income stream from twenty printings. Mr. Cohen negotiated the figure down to twelve printings. (A83-84.) There were "tooth and nail" negotiations between Mr. Cohen and Price, Stern and Sloan. (A107.)

Negotiations with Walter Zacharius, president of Kensington Publishing, were particularly contentious; on the terms and conditions offered, Mr. Zacharius refused to accept lower prices. (A82.)

Before the purchases were consummated, Universal, Townsend and the Partherships retained experts such as James Bryans, publisher of *To Kill a Mockingbird*, to evaluate the reasonableness of the purchase prices. (A111.) When an expert thought that the price for a particular Property was too high, Mr. Cohen renegotiated or declined to purchase the Property. (A88.)

In negotiating each of the purchases, Mr. Cohen sought to acquire as many Properties for as little cost as possible because he believed that ownership of more Properties for the same cost would increase the likelihood of profits. (A96.) Additionally, the smaller the initial cash outlay required, the more Properties Townsend and Universal could afford to acquire. (A89-90;96.) Mr. Cohen also believed that the publishers' affiliates were more likely to fulfill their obligations to promote the Works vigorously if they received less cash up front and would receive additional payments, over the near term, solely upon successful sales. (A106.) As such, in negotiating each purchase, Mr. Cohen employed recourse debt, represented by a small cash down payment and a twelve-year promissory obligation. (A91-93;103.) Asked at trial for his incentive for keeping the notes and purchase prices low, Mr. Cohen testified: "I tried to buy twice as many of these very same books for the same amount of money and was turned down." The same tax credit would have been available had he done so, "[a]nd it would have been easier to pay off the notes . . .." (A87.)

2. The Evidence Introduced by the Government.

At trial, the government did not introduce any direct evidence about the negotiations themselves. It offered no evidence of collusion, or of any secret agreements that would affect the validity of the transactions or the debt instruments. Instead, the government introduced *post hoc* subjective appraisal evidence through four appraisers. Works from six "test" Partnerships[5] were divided among these appraisers. These government appraisers read the Works, gave personal opinions about their quality and subject matter, and opined as to the number of copies of each Work they believed would sell. These appraisers' sales estimates were so low that the publishers, who had invested substantial sums in the Properties before bringing a single book to market, would not have made a profit. (A104-05.)

The government's appraisers did not pretend that their method was objective. A few examples from testimony and 273 written appraisals illustrates the subjective nature of their evaluations.

One government appraiser, Thomas Congdon, acknowledged that "[r]easonable people might differ" with his projections (A75) and agreed that "the publishing business is like drilling for oil, you lose a lot of times and sometimes you hit it." (A73-74.) Mr. Congdon admitted that his publishing decisions are made based on whether he has a "tingle" about a book. (A74.) He testified that he once purchased a book because he had "the real zap," but conceded that this purported methodology "doesn't always work." (*Id.*) Of Nicholas Proffit's *Garden's of Stone*, one of the Works at issue, Mr. Congdon testified: "I wouldn't have a zap on that book. It was a sort of dull thud for me." (A74.)

Gloria Mosesson, who appraised 199 of the 273 Works appraised by the government, explicitly declined to say the sales figures were "objectively arrived at." (A71-72.) She testified that she based her sales figures on "me as a consumer and on me as a publisher," and that she arrived at her sales estimates "by having vibes of what was going on. . .." (A65-66, 70.)

Ms. Mosesson appraised a novel by Samuel Beckett entitled *Worstword Ho!* She criticized the work because its cover was not, in her judgment, sufficiently colorful, and she regarded the book as a "joke."

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[5]The parties stipulated that evidence as to the Properties' values would be presented as to only six Partnerships and that the jury's findings as to these Properties would apply to all the Properties in the other Partnerships.

(A57-59, 62-63.) Although Universal purchased the Property for $325,000, Ms. Mosesson judged the book to be worth $3,291. (A59-60.) Discussing *The Flying Devis of Dunhuang*, an art book purchased by Universal, Ms. Mosesson, in describing Chinese paintings it portrayed, commented, "if you have seen one, you see them all." (A56.) She acknowledged that whether a person finds such paintings interesting "[is] a very subjective thing." She did not find them interesting. (A61.)

Ms. Mosesson said the art work for the cover of the book *All the Love Poems of Shakespeare* was "not a smash. I don't think it is especially a pretty jacket cover." (A63-64.) Ms. Mosesson's written appraisal of *Windhaven's Destiny*, a mass-market paperback that was part of a best-selling series, states: "Although this series has apparently had sales success, it would seem that there is a limit to how much you can drag on the story of a family like this. . .. In addition, the book is not written well enough to make a reader want to wait for the next episode in the story of this family." (A116.) Citing no independent research, Ms. Mosesson went on to question the publisher's veracity in stating on the book jacket that nine million copies of the series had already been sold. (*Id.*)

Charles Seldon appraised the test Partnerships' computer software and books. Mr. Selden termed "odd" and "disgraceful" the educational software developed by Roger Schank, Chair of Yale University's Computer Science Department, and gave the software a fair market value of $ 0. (A51.) He gave *The Personal Computer in Advertising*, a book featured in one of Banbury Books, Inc.'s promotional brochures, a fair market value of $ 0. (A126.) Mr. Seldon even gave a $ 0 value to two books chosen for distribution by Putnam, one of the country's major book distributors. (A53-54.) In fact, Mr. Selden assigned fair market values of $ 0 to twelve of the seventeen Works he appraised, suggesting, in essence, that their creators and publishers would have given them away in arm's length transactions. (A126.)

The fourth government appraiser, Edward Knappman, discussing *Classics of the Silent Screen*, a book by television personality Joe Franklin that had been in print since 1959, opined that the number of people who would be interested in this genre would be substantially diminished by 1983. He admitted that a subject like silent movies "has very little interest to me." (A45-49.)

THE VERDICT AND JUDGMENT

Petitioners moved for directed verdicts at the close of the government's case and at the close of the evidence. These motions were predicated on Petitioners' contention that the appraisal evidence produced by the government, which bore the burden of proof, was irrelevant and insufficient as a matter of law because there was uncontradicted evidence of arm's length bargaining. These motions were denied. Presented with the *post hoc*, subjective appraisal testimony that the Partnerships' Works were doomed to fail, the jury found that the Properties in the six test partnerships were overvalued. After briefing, the district court calculated the penalties for each Petitioner and entered judgment in the amounts of $400,000 for Madison, $4,395,925 for Townsend, $8,994,367 for Universal, $534,692.50 for Barrister, $1,446,712.50 for Parliament, $9,667.00 for Paul Belloff, and $9,667.00 for Robert Gold. Petitioners' motions for judgment not withstanding the verdict or a new trial were denied without opinion.

THE COURT OF APPEALS DECISION

Petitioners appealed to the United States Court of Appeals for the Second Circuit, challenging the trial court's denial of their motions for a directed verdict and for a judgment notwithstanding the verdict or a new trial. The Petitioners argued that the finding of gross overvaluation should be reversed because the Properties' values were established in arm's length bargaining and the government's *post hoc*, subjective appraisal evidence was irrelevant and inadmissible.

Notwithstanding the uncontradicted testimony that the transactions were conducted at arm's length and the absence of any evidence of collusion, the Second Circuit affirmed. In explaining its affirmance, the Second Circuit held that the jury could have concluded that the negotiations were not arm's length because tax factors were considered in structuring the transactions.

The Second Circuit also held that the trial court properly permitted the jury to consider the government's *post hoc* appraisal evidence in determining whether the transactions were at arm's length and further held that the government's appraisal evidence was not too subjective to be admissible.

REASONS FOR GRANTING THE WRIT

I. THE SECOND CIRCUIT OPINION, IN CONTRAVENTION OF THIS COURT'S ESTABLISHED AUTHORITY, IMPROPERLY HELD THAT BECAUSE FAVORABLE TAX CONSEQUENCES WERE CONSIDERED BY PETITIONERS DURING THE NEGOTIATIONS, THE NEGOTIATIONS WERE NOT ARM'S LENGTH.

The uncontradicted testimony at trial was that the purchase prices of the Properties, including the amount of cash down payment and debt, were negotiated in arm's length transactions between unrelated parties, with the adverse parties seeking their own best economic advantages. These negotiations established the Properties' fair market values. *See United States v. Cartwright*, 411 U.S. 546, 551 (1973); *Abramson v. Commissioner*, 86 T.C. 360, 371-73 (1986). The entire cost of the Properties, including the recourse debt, was therefore properly taken into account in determining the amount of tax credit that could be passed through to the Partnerships. I.R.C. Section 46(c)(1), 1012. *See Rice's Toyota World, Inc. v. Commissioner*, 752 F.2d 89, 96 (4th Cir. 1985); I.R.C. Section 465(b)(2) (recourse debt is considered "at risk" for the purposes of determining permissible extent of deductions or credits).

Petitioners did not dispute at trial and do not now dispute that the tax credits to be gained played a role in their decision to negotiate the purchases in this manner. However, the uncontradicted testimony at trial also established that there were business reasons for negotiating the purchases in this manner. The smaller the cash outlay, the more Properties Townsend and Universal could afford to purchase. In addition, the publishers were more likely to fulfill their obligations to promote the Works produced vigorously if they received less cash up front and would receive additional payments near term based solely upon successful sales. (*See supra p. 6*).

The Second Circuit was disturbed that favorable tax consequences were taken into account in structuring the transactions in this fashion. The court held that that fact was a sufficient basis for the jury to have found an absence of arm's length bargaining: "An arm's-length transaction between a buyer and seller is one untainted by motives other than the desire of each to obtain the best price." *In re MDL-731 -- Tax Refund Litigation*, 989 F.2d 1290, 1298 (2d Cir. 1993); (A1, 15). In this case, the opinion states, tax reduction was the impermissible other motive. *Id.* at 1298-99; (A15-16).

This Court has held, however, that there is nothing improper about taking favorable tax consequences, along with other business considerations, into account in deciding how to structure a business transaction. *Frank Lyon Co. v. United States*, 435 U.S. 561, 580 (1978). "The fact that favorable tax consequences were taken into account on entering into a transaction is no reason for disallowing those consequences." *Id. See also Commissioner v. Wodehouse*, 337 U.S. 369, 410 (1949) ("The fact that the incidences of income taxation may have been taken into account by arranging matters one way rather than another so long as the way chosen was the way the law allows, does not make a transaction something else than it truly is – it does not turn a sale into a license") (Frankfurter, J., dissenting) (citation omitted); *Rosenfeld v. Commissioner*, 706 F.2d 1277, 1281 (2d Cir. 1983) ("Many financial decisions are motivated by the prospect of legitimate tax savings . . .. [A] transaction is not unlawful merely because an individual seeks to minimize the tax consequences of his activities"); *Brooke v. United States*, 468 F.2d 1155, 1158 (9th Cir. 1972) (where record reflected non-tax motives as well as tax savings motives were behind taxpayer's decision to transfer building to his children, deductions would not be disallowed); *Helvering v. Gregory*, 69 F.2d 809, 810 (2d Cir. 1934) ("Anyone may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose a pattern which will best pay the Treasury") (Hand, J.), *aff'd*, 293 U.S. 465 (1935).

The Second Circuit's use of the term "best price" to define arm's length bargaining also appears to overthrow the established principle that current deductions and tax credits may be taken on a price payable over time, even if that price is higher than an all-cash price might have been. *Abramson v. Commissioner*, 86 T.C. 360, 371 (1986); *Sheid v. Commissioner*, 50 T.C.M. (CCH) 663 at n. 29 (1985). Prior to the Second Circuit's opinion, debt had not previously, in and of itself, been thought to "taint" otherwise arm's length bargaining.

By holding that consideration of tax consequences is sufficient grounds to disregard a negotiated purchase price and to overcome uncontradicted testimony that the bargaining was at arm's length, the opinion brands the great majority of business transactions as not arm's length. If the Second Circuit's opinion is allowed to stand, any leveraged transaction in which the interest deduction under I.R.C. Section 163 is taken into account, for example, will be fair game for the Internal Revenue Service.

It is respectfully submitted that the opinion is in contravention of this Court's established authority and certiorari should therefore be granted.

II. THE SECOND CIRCUIT'S APPROVAL OF THE ADMISSION OF POST HOC APPRAISAL EVIDENCE TO ESTABLISH THAT A BUSINESS TRANSACTION WAS NOT BONA FIDE PLACES IT IN CONFLICT WITH THE DISTRICT OF COLUMBIA CIRCUIT AND OTHER FEDERAL COURTS.

In order to establish that Townsend and Universal's negotiations with the publishers were not at arm's length and that the purchase prices for the Properties were inflated, the government introduced the testimony of expert witnesses who testified, eight years after the fact, as to what values *they* would have placed on the Properties at the time and what Properties they would have considered purchasing. These witnesses, stating their personal opinions, adjudged that virtually all of the prices paid by the Petitioners were inflated. Indeed, these witnesses testified that many of the Properties, in which the publishers had already invested substantial sums of money (*see supra pp.2-3*), had no market value at all. (*See supra p. 8*).

The Second Circuit opinion held that it was proper for the district court to permit the jury to consider these appraisers' *post hoc* business judgments in determining whether the negotiated prices were intentionally inflated. This holding places the Second Circuit in conflict with the United States Court of Appeals for the District of Columbia Circuit and other federal courts, and sets a dangerous precedent.

In *Cornfeld v. Commissioner*, 797 F.2d 1049 (D.C. Cir. 1986), the United States Court of Appeals for the District of Columbia Circuit explicitly rejected the use of hindsight in tax cases as a basis for attacking the bona fides of a business transaction, and in particular, the prices paid by the taxpayer for a property.

In *Cornfeld*, the taxpayer purchased a passenger jet aircraft and pursuant to I.R.C. Section 183 sought business deductions attributable to the ownership of this aircraft. The I.R.S. challenged the business deductions by alleging that the prices paid for the purchase and modification of the aircraft were excessive and that these activities were not undertaken "for profit." *Id.* at 1051.

The Tax Court ruled for the I.R.S., in part because, in the Tax Court's judgment, the taxpayer's decision to expend substantial sums of money to remodel the aircraft could not have "'enhanced the prospect of profits.'" 797 F.2d at 1053 (quoting from Tax Court opinion).

The District of Columbia Circuit, in reversing the Tax Court, rejected the use of hindsight:

> We cannot approve such second-quessing of business judgments by the court. The question is not whether we, or the Tax Court judge, think a particular mode of doing business is wise, but whether the taxpayer honestly believed that the method he employed would turn a profit for him. . ..

Id. at 1053.

This sort of second-guessing is exactly what the Second Circuit approved in this case. The government's appraisers acknowledged that their appraisals were based on their own personal business judgments, judgments about which others might differ. Yet the Second Circuit permitted the factfinder to find a lack of bona fide arm's length bargaining based on those appraisers' judgments, *i.e.*, based on the appraisers' testimony that their business judgments differed from Petitioners' judgments. By permitting the jury to give the appraisers' hindsight judgments controlling weight, the Second Circuit placed itself squarely in conflict with the District of Columbia Circuit.

Other federal courts have also rejected the use of *post facto* business judgments in tax cases.

In *Wright v. United States*, 249 F. Supp. 508 (D. Nev. 1965) the court trenchantly rejected an attempt by the I.R.S. to use hindsight business judgments to challenge taxpayer business deductions. In *Wright*, the I.R.S. argued that the taxpayer, a farmer, was not entitled to deductions for business losses, because, in the I.R.S.'s judgment, the farmer should have abandoned the enterprise after it experienced operating losses for several years. The court, finding that there was uncontradicted evidence that the taxpayer embarked upon and operated the farming enterprise in good faith, rebuked the I.R.S. for its attempt to introduce *post hoc* business judgments:

> [E]ach taxpayer is entitled to conceive and embark upon his own business enterprise, no matter how impractical, idiosyncratic or questionable of success it may seem to others. . . It is not for the Collector to second-guess the taxpayer. . .[n]or it is it for the Collector to criticize the particulars of the management of the business. Such Monday morning quarterbacking is easy, but it should be acknowledged somewhere along the line that if the success of

> American business should be made to depend on the business acumen of the Collector of Internal Revenue rather than the enterprise, imagination, initiative and gambling instinct of the American businessman, little progress would be probable.

Id. at 249. *See also King v. United States*, 545 F.2d 700, 709 (10th Cir. 1976) ("We cannot, by hindsight, disallow a deduction simply because the [investment] did not prove to be profitable").

The Tax Court has also rejected the use of *post hoc* appraisal evidence where there has been no independent demonstration that there was an absence of arm's length bargaining. *Sheid v. Commissioner*, 50 T.C.M. (CCH) 663, 670 n. 24 (1985) ("Conceivably in some circumstances such testimony may help us to arrive at the conclusion that the purchase price represents fair market value, *but where that determination is made independently, appraisal evidence becomes immaterial.*") (emphasis added). *Accord Abramson v. Commissioner*, 86 T.C. 360, 372 & n. 16 (1986) (rejecting *post hoc* appraisal evidence as "immaterial" when the taxpayer had demonstrated that the purchase price was the result of arm's length, good faith bargaining).

Indeed, one eminent tax authority has stated that when, as here, an expert's valuation is made years after the transaction at issue and there is other evidence establishing market value, the expert's opinion has no probative value. "If the valuation is made several years after the basic date, the expert's opinion will be regarded as lacking in probative value, especially where there is other evidence showing a different value." 15 *Mertens Law of Federal Income Tax*, § 59.11 at 37 (1992).

Because such hindsight is not probative, it is not admissible under either Rules 702 or 401 of the Federal Rules of Evidence. *See* Rule 702 (permitting the admission of expert testimony only where it "will assist the trier of fact to understand the evidence or to determine a fact in issue. . ."); Rule 401 ("'Relevant evidence' means evidence having any tendency to make the existence of any fact that is of consequence to the determination of the action more probable than it would be without the evidence.")

The approach followed by *Cornfeld* and the other cited authorities is salutory. A litigant will always be able to find appraisers whose *post hoc* business judgments differ from the parties to those transactions. When speculative investments are involved, and particularly in an industry such as publishing, where publishers' judgments differ so widely, knowledgeable people will have very different judgments about the commercial potential of a venture. As such, the *post hoc* judgments even

of expert appraisers are not probative of whether, at the time of the transactions, the purchaser believed in good faith in the profit potential of the venture and bargained at arm's length.

Indeed, it is hard to see how any *post hoc* appraiser in an industry for which success depends on public acceptance could be unaffected by knowledge of whether the work under evaluation was a success. Knowledgeable people would know of a work if it was a commercial success; if they had not heard of it, the inference would be that it was not. For *post hoc* appraisers to place themselves in the position of a purchaser prior to the work's distribution is akin to efforts to unring a bell. As one court has succinctly stated: "Would an experienced financial analyst testify to a price valuation that subsequent events demonstrated was too high? How much probative force can be given a projection that is confidently put forth in the knowledge that subsequent events bore it out?" *Simon v. New Haven Board and Carton Company*, 393 F. Supp. 139, 145 (D. Conn. 1974), *aff'd*, 516 F.2d 303 (2d Cir. 1975).

This approach does not leave the government without a remedy. At trial, through the examination and cross-examination of the participants in and witnesses to the negotiations, as well as critical scrutiny of contemporaneous documentary evidence, the government may delineate for the jury the objective facts that were ascertainable at the time the transactions occurred and attempt to demonstrate therefrom that the negotiations were not arm's length and undertaken in good faith. *Cf. Bixby v. Commissioner*, 58 T.C. 757 (1972) (Tax Court disregarded a purchase price where there was a large step-up in price negotiated between related parties).

Because there was no independent demonstration that there was an absence of arm's length bargaining, Petitioners' motions for a directed verdict and for judgment notwithstanding the verdict should have been granted. Alternatively, if the issue was properly submitted to the jury, it should have gone with the instruction that the jury was not to consider the appraisal evidence unless it first determined that arm's length bargaining had not occurred, not with the vague instruction to give the evidence "such weight as *you may think it deserves*" (emphasis added). (A108.)

III. SUBJECTIVE APPRAISAL EVIDENCE IS IRRELEVANT AND INADMISSIBLE.

The government's appraisal evidence was also so highly subjective and, therefore, so irrelevant and prejudicial, that its submission to the jury violated Rules 401 and 702 of the Federal Rules of Evidence.

As noted, four government appraisal witnesses read the Works (one appraiser per Work) and offered their personal reactions to the Works' quality and subject matter. Based on these reactions, they estimated the likely sales volume of each Work and a projected a net income figure to a hypothetical publisher. Many of the appraisals resulted in fair market values of $ 0. The appraisers made no pretense that their appraisals were objective. One appraiser admitted that her estimates were based on her own views as a consumer and a publisher, were arrived at by having "vibes of what is going on. . .," and explicitly declined to say the estimates were "objectively arrived at." She regarded a Work by Samuel Beckett as a "joke," and commented that whether the subject matter of a book on Chinese art was interesting was "a very subjective thing." Another government appraiser conceded that he made sales projections based on whether his reaction to the Work was a "tingle," "zap," or "dull thud." The Second Circuit held that it was permissible for such highly subjective testimony to go to the jury.

In so holding, the Second Circuit placed itself in conflict with other federal circuits. Other circuit courts, pursuant to both Rules 401 and 702 of the Federal Rules of Evidence, have held subjective expert testimony inadmissible because such evidence is of little probative value and has the tendency to prejudice the jury. As the United States Court of Appeals for the Fifth Circuit has cogently held: "Without more than credentials and a subjective opinion, an expert's testimony that 'it is so' is not admissible." *Viterbo v. Dow Chemical Co.*, 826 F.2d 420, 424 (5th Cir. 1987). *See United States v. Whitted*, 1993 U.S. App. Lexis 11942 (8th Cir. May 24, 1993) (doctor's subjective testimony should have been held inadmissable under Rule 702 because in light of the witness's stature as an expert there was a danger that the jury overlooked the subjective nature of his testimony and "surrendered its own common sense. . ."); *Loudermill v. Dow Chemical Co.*, 863 F.2d 566, 570 (8th Cir. 1988) (expert testimony lacking objective factual support cannot help the jury and is inadmissible under Rule 702); *accord Marks v. Pan American World Airways, Inc.*, 785 F.2d 539, 542 (5th Cir. 1986) (under Rule 702 an award of damages "'cannot stand when the only evidence to support it is speculative or purely conjectural.'") (quoting *Haley v. Pan American World Airways,*

Inc., 746 F.2d 311, 316 (5th Cir. 1984)); *Johnson v. Serra*, 521 F.2d 1289, 1293 (8th Cir. 1975) (trial court abused its discretion in admitting expert testimony that was "too speculative and conjectural, thus lacking sufficient probative value to outweigh the danger that it would lead the jury to assess damages on an improper basis.") (citations omitted). Indeed, this was the rule in the Second Circuit prior to this case. *See Jacobson v. Commissioner*, 915 F.2d 832, 838-39 (2d Cir. 1990) (rejecting a "Siskel and Ebert 'thumbs up, thumbs down'" approach to valuing speculative investments).

The Tax Court has also rejected the use of subjective appraisal evidence. In *Abramson v. Commisioner*, 86 T.C. 360 (1980), which concerned a partnership's investment in a motion picture, the Tax Court held that it was impermissible to consider subjective appraisal evidence in evaluating the purchase price: "[R]espondent's appraisers were far from impressive. They gave every indication that they were simply performing by rote, in a biased fashion, the task for which they had been employed. *In addition, at least one of the appraisers obviously allowed his personal distaste for [the motion picture] to override his objectivity.*" 86 T.C. at 372 n. 16. (emphasis added).

The Second Circuit here was not "troubled by the fact that each of the appraisers' evaluations may contain an irreducible subjective element." 989 F.2d at 1299; (A16). The court held that this highly subjective appraisal evidence could properly be considered by the jury without prejudicing Petitioners because Petitioners had "ample opportunity during cross-examination to explore any subjective considerations underlying the experts' appraisals and to cast doubt on the reliability of those appraisals, [were] . . . free to argue to the jury that the appraisers' valuations were inherently unreliable because of subjective considerations," and because "[t]he jury, adequately instructed on the weight to accord expert testimony, was thus in a position to balance the competing opinions and to determine the actual values of the Properties on an informed basis." *Id.* at 1299-1300; (A17).

Rules 401 and 702, Fed. R. Evid., however, require that the courts assume a more active gatekeeping function with respect to expert evidence than the Second Circuit adopted in this case. As one court has aptly put it:

> As with any other kind of evidence, Rule 401 could be ignored in favor of reliance upon the enlightening effects of cross-examination; the courtroom could become a true "marketplace of ideas" where no statement of fact would be too absurd not to have its day in court. It is plain that a court would prolong trials, confuse the trier of fact and invite unprincipled results if it ignored the fundamental judicial function of screening evidence that does not meet the threshold test of raising a reasonable probability of a fact.

Porter v. Whitehall Labs., Inc., 791 F. Supp. 1335, 1345 n. 10 (S.D. Ind. 1992). *See also In re Air Crash Disaster at New Orleans, L.A.*, 795 F.2d 1230, 1235 (5th Cir. 1986) ("We will turn to the task [of reviewing the decision to admit expert testimony] with a sharp eye, particularly in those instances, hopefully few, where the record makes evident that the decision to receive expert testimony was simply tossed off to the jury under a 'let it all in' philosophy.")

Because the evidence relied on by the government to establish that the transactions were not arm's length and that the purchase prices were inflated was incompetent and inadmissible subjective appraisal evidence, Petitioners' motions for a directed verdict and for a judgment notwithstanding the verdict should have been granted for failure of sufficient proof to permit the jury reasonably to find for the government. *Sirota v. Solitron Devices, Inc.*, 673 F.2d 566, 573 (2d Cir.) (setting forth standards on motion j.n.o.v.), *cert. denied*, 459 U.S. 838 (1982). At a minimum, Petitioners should have been granted a new trial free of the influence of the government's subjective appraisals.

CONCLUSION

For the foregoing reasons, Petitioners respectfully pray that the Court issue a writ of certiorari to review the judgment of the United States Court of Appeals for the Second Circuit.

Dated: August 18, 1993

Respectfully submitted,
JULES RITHOLZ
COUNSEL OF RECORD

DAVID M. KOHANE
ROSS N. HERMAN

KOSTELANETZ RITHOLZ
TIGUE & FINK
80 Pine Street
New York, New York 10005
(212) 422-4030

Attorneys for Petitioners

APPENDIX A

IN RE MDL-731–TAX REFUND LITIGATION OF ORGANIZERS AND PROMOTERS OF INVESTMENT PLANS INVOLVING BOOK PROPERTIES LEASING.

BARRISTER ASSOCIATES, Paul Belloff, Parliament Securities Corp., Robert Gold, Madison Library, Inc., Universal Publishing Resources, Ltd. and Geoffrey Townsend, Ltd., Plaintiffs-Appellants-Cross-Appellees,

v.

UNITED STATES of America,
Defendant-Appellee-Cross-Appellant.

Nos. 1376, 1405 and 1406, Dockets 91-6289, 91-6291 and 91-6317.

United States Court of Appeal, Second Circuit.

Argued April 9, 1992
Decided March 22, 1993.
(Reported at 989 F.2d 1290)

Taxpayers brought action for refund of penalty assessed for promoting and organizing allegedly abusive tax shelters and government counterclaimed for payment of assessed penalties. Jury found that taxpayers had promoted abusive tax shelter and the United States District Court for the Eastern District of New York, Thomas C. Platt, Jr., Chief Judge, 766 F.Supp. 1248, imposed penalties. Appeal was taken. The Court of Appeals, Winter, Circuit Judge, held that: (1) government's appraisal testimony was relevant; (2) government was not required to assess penalties only on income actually earned during discrete taxable period; (3) earnings expected but never received were properly included in gross income base; (4) general partnerships could not exclude cost of sales and goods when calculating gross income; and (5) penalty could not be imposed on same income from both general partnerships and general partners.

Affirmed in part and reversed in part.

1. Internal Revenue 5230

Three-year statute of limitations does not apply to assessment of penalties for promoting abusive tax shelter. 26 U.S.C.A. § 6501(a).

2. Internal Revenue 5219.50

Penalty for promoting abusive tax shelter applies to either gross valuation overstatements or false or fraudulent statements. 26 U.S.C.A. § 6700.

3. Internal Revenue 5237

Whether gross valuation overstatement has been made which justifies penalty for promoting abusive tax shelter is question of fact upon which government bears burden of proof. 26 U.S.C.A. § 6703(a).

4. Internal Revenue 5219.50

Correct or fair market value of a good, used to determine whether penalty should be imposed for promoting abusive tax shelter based on gross valuation overstatement, is price at which willing buyer would purchase the good from willing seller. 26 U.S.C.A. § 6700(b)(1).

5. Internal Revenue 5219.50

Price arrived at through arm's-length negotiations is usually most reliable evidence of fair market value but is not conclusive when determining whether individual has made gross valuation overstatement justifying penalty for promoting abusive tax shelter. 26 U.S.C.A. § 6700(b)(1)

6. Internal Revenue 5232.1

Appraisal evidence as to property purchased by limited partnerships was relevant to whether gross valuation overstatement had been made, thereby justifying penalty for promoting abusive tax shelter. 26 U.S.C.A. § 6700(b)(l); Fed.Rules Evid. Rule 702, 28 U.S.C.A.

7. Internal Revenue 5232.1

Fact that appraisers' valuations of properties purchased by limited partnership contained subjective element did not make valuations unreliable basis for calculating penalty for promoting abusive tax shelter based on gross valuation overstatement. 26 U.S.C.A. § 6700(b)(1); Fed.Rules Evid. Rule 702, 28 U.S.C.A.

8. Internal Revenue 5219.50

Penalty for promoting abusive tax shelter may be assessed on future earnings; government is not obligated to assessing penalties only on income actually earned during discrete taxable periods. 26 U.S.C.A. § 6700.

9. Internal Revenue 5219.50

Penalty for promoting abusive tax shelter may be imposed based on earnings which promoters expected but never in fact received, where promoters could have brought suit to recover unpaid fees at time of first assessment. 26 U.S.C.A. § 6700.

10. Internal Revenue 5233

Government is entitled to presumption that assessment of penalties for promoting abusive tax shelter is correct and taxpayer has burden when question concerning size of penalty. 26 U.S.C.A. § 6700.

11. Internal Revenue 5220

Commissions paid by promoter to sales representatives could not be excluded from promoter's gross income when calculating size of penalty for promoting abusive tax shelter. 26 U.S.C.A. §§ 61(a), 6700.

12. Internal Revenue 5220

Income to promoters in form of rent payments from limited partnerships were properly included in promoters' gross incomes when calculating penalty for promoting abusive tax shelters. 26 U.S.C.A. §§ 61(a) 6700

13. Internal Revenue 3021

Penalties for promoting abusive tax shelter could not be assessed against both income general partnership received for arranging shelters and that same income which general partners later received from partnership; imposing penalty on both general partners and partnership based on same income constituted unauthorized double tax. 26 U.S.C.A. § 6700.

14. Internal Revenue 5220

Transfer of ownership of general partnership from general partners to their spouses did not require that future income be excluded from gross income base on which penalties for promoting abusive tax shelter were assessed; transfers, without more, did not demonstrate that

general partners' interest in future income had in fact been eliminated. 26 U.S.C.A § 6700.

David M. Kohane, New York City (Jules Ritholz, Atea Martin, Kostelanetz Ritholz Tigue & Fink, of counsel), for plaintiffs-appellants-cross-appellees Madison Library, Inc., Universal Pub. Resources, Ltd. and Geoffrey Townsend, Ltd.

Nathan M. Silverstein, New Haven, CT (Kurt F. Zimmermann, Silverstein & Osach, P.C., of counsel), for plaintiffs-appellants-cross-appellees Barrister Associates, Paul Belloff, Parliament Securities Corp., and Robert Gold.

Steven W. Parks, Atty., Tax Div., Dept. of Justice, Washington, DC (James A. Bruton, Acting Asst. Atty. Gen., Gary R. Allen, Jonathan S. Cohen, Attys., Tax Div., Dept. of Justice, Washington, DC, Andrew J. Maloney, U.S. Atty., E.D.N.Y., Brooklyn, NY, of counsel), for defendant-appellee-cross-appellant.

Before FEINBERG, WINTER and ALTIMARI, Circuit Judges.

WINTER, Circuit Judge:

This is an action for a refund of penalties paid to the Internal Revenue Service ("IRS") pursuant to Internal Revenue Code ("I.R.C.") § 6700 (1982). In 1986, the IRS assessed penalties against each of the appellants for promoting and organizing allegedly abusive tax shelters. After paying fifteen percent of the assessments, appellants filed suit for a refund, pursuant to I.R.C. § 6703 (1982). The government counterclaimed for payment of the remaining eighty-five percent of the penalties assessed.

On July 11, 1990, following a jury trial before Chief Judge Platt, each of the seven appellants was found to have promoted or organized an abusive tax shelter and was therefore liable to pay the penalty imposed by I.R.C. § 6700. By memorandum and order, later amended, the district court determined the amount of the penalty owed by each appellant. *In re Tax Refund Litigation*, 766 F.Supp. 1248 (E.D.N.Y.1991). On appeal, appellants attack both the jury's finding of liability and the district court's calculation of penalties. The government cross appeals, arguing that the district court failed to include certain income purportedly earned by two

of the appellants–Robert Gold and Paul Belloff. We affirm on the appeal and affirm in part and reverse in part on the cross-appeal.

BACKGROUND

1. *The Parties*

Central to the tax shelters at issue were three individuals–appellants Robert Gold and Paul Belloff, and Irving Cohen, who is not a party to the instant action. Gold, Belloff, and Cohen, or some combination of the three, were the shareholders, corporate officers, or general partners of each of the organizations responsible for promoting and organizing the tax shelters.

Irving Cohen founded and served as the president and director of appellant Madison Library, Inc. ("Madison"), a Nevada corporation with its principal place of business in Las Vegas. All of Madison's stock is directly or indirectly owned by, or held in trust for, Cohen's children. Madison, in turn, is the corporate parent of appellants Geoffrey Townsend, Ltd. ("Townsend") and Universal Publishing Resources, Ltd. ("Universal"), also Nevada corporations with their principal place of business in Las Vegas. Cohen is the chief executive officer and president of Townsend and Universal, whose stock is also held in trust for Cohen's children.

Appellant Barrister Associates is a New York general partnership established in 1981 by Belloff and Gold, who serve as general partners. It was formed to organize and act as general partner of, *inter alia*, the ninety-five limited partnerships relevant to the instant matter–Barrister Equipment Associates Series 81 through 167, 171 through 175, 201, 301, and 302.

Appellant Parliament Securities Corp., formally known as Chadwick Investment Co. ("Chadwick"), is a New York subchapter S corporation. At most pertinent times, Gold, Belloff, and Ronald Cohen (not related to Irving Cohen) each owned one-third of Chadwick's outstanding stock. Chadwick was responsible for marketing the Barrister Equipment Associates limited partnerships to investors.

2. *The Transactions and Their Tax Consequences*

The tax shelters promoted by appellants involved the 1982 and 1983 purchase and subsequent leasing of certain properties, *i.e.*, metallic plates, lithographic films, and other equipment used in the printing of soft and hard cover books, and unencrypted master computer discs used in the manufacturing of computer software (the "Properties"). Townsend and Universal, through their president and CEO Irving Cohen, negotiated with a number of different publishers to purchase the Properties.

The transfer of each of the Properties was effectuated by an acquisition agreement, executed by the purchaser (Townsend or Universal) and the publisher. The terms of each purchase were essentially identical–Townsend to Universal made a small downpayment, usually representing two or three percent of the purchase price, and executed a recourse promissory obligation for the remainder. (This obligation was referred to throughout the trial as a promissory note, although no note separate from the acquisition agreement existed. We will also use the term "promissory note" to identify Townsend's and Universal's obligation.) A chattel mortgage on the Properties secured each of the promissory notes. These notes matured approximately twelve years after execution and bore interest at a rate of nine percent per annum. No payments (interest or principal) were due during the intervening twelve years except to the extent the works produced from the transferred Properties realized net revenues. After twelve years, Townsend and Universal were obligated to make balloon payments of all remaining unpaid interest and principal.

The purchase price of the Properties was arrived at in negotiations between a representative of the particular publisher and Irving Cohen. The actual method of determining the price varied, depending upon which publisher was selling the Property. Generally, however, the purchase price was a percentage of the income stream from an agreed-upon number of printings of a book or piece of software. That is, the price was derived by multiplying the quantity of books or software produced in each of five or seven printings (or some other number, depending on the seller) by a set payment per copy (the amount of this payment was higher for the first printing than for subsequent printings). An exhibit attached to the acquisition agreement for each Property indicated the number of copies to be distributed in the initial printing. This number was agreed upon by the publishers and Cohen. For

purposes of determining the purchase price, Cohen and the publishers appear to have assumed that the same number of copies would be produced in all subsequent printings.

The Properties were purchased for widely varying amounts–from a minimum of about $100,000 to well over $1,000,000. According to Gold's testimony, Townsend and Universal purchased 3,774 Properties during 1982 and 1983. Because they made only a small downpayment and executed a promissory agreement for the balance, Townsend and Universal took on large debt obligations pursuant to their 1982 and 1983 purchases. Townsend, the purchasing entity for 1982, owed $627,155,989 at the end of that year (excluding any interest). Universal, which was responsible for the 1983 purchases, had an outstanding debt of $1,313,061,699 (again excluding any interest). Putting aside any cash downpayment the 3,374 Properties purchased by Townsend and Universal during 1982 and 1983 cost, on average, over $500,000 per Property.

Most of the books and software to be produced from the Properties had never before been published. None, at least, had ever before been published in the same form. All were ready for publication. The books and software covered a wide range of topics, and included such titles as *Drinking with Dickens, The World of the Older Woman, More Pac-Mania, World of Horses Coloring Album*, and *Berserker Raids*.

After purchasing the Properties, Townsend and Universal leased a bundle of diverse Properties representing about forty works (books or software) to each of the ninety-five Barrister Equipment Associates limited partnerships. (Townsend acted as lessor for the thirty-five limited partnerships established in 1982, Universal for the sixty established in 1983.) The terms of the leases were formalized in lease agreements, executed by Townsend or Universal and the relevant Barrister Equipment Associates limited partnership. The leases remained in effect for approximately eight years after the Properties were delivered and obligated the limited partnerships, as lessees, to make annual rent payments to either Townsend or Universal.

Under I.R.C. §§ 38 and 46(a)(2)(B), Townsend and Universal were allowed, disregarding other possibly relevant tax rules, a credit against their federal income taxes. This was ten percent of the value of the purchased Properties during 1982, and eight percent during 1983, even though only a small fraction of the purchase price had been paid.

The lessors–Townsend or Universal–then made a pass-through election pursuant to I.R.C. § 48(d). The Section 48(d) election designated the limited partnerships as the beneficiaries of this credit as to all Properties each partnership leased.

A partnership, however, is generally not a taxable entity, *see* I.R.C. § 701, and this investment tax credit was enjoyed by the individual partners of the limited partnerships. Each partner acquired a proportionate share of the credit, based on his or her capital interest in the partnership, and each was allowed to take advantage of this share when filing his or her personal income tax return. Additionally, each of the partners took a tax deduction based on his or her proportionate share of the operational expenses of the partnership. In combination, this credit and deduction produced attractive tax consequences for wealthy investors. A brochure used to market one of the limited partnerships–Barrister Equipment Associates Series 115–indicated that, in return for a $50,000 investment, an investment tax credit of $50,600 ($43,100 in 1983 and $7,500 in 1984), as well as tax deductions of $15,000 for 1983 and $35,000 for 1984, would become available. Assuming an investor was in the fifty-percent income tax bracket, the brochure advised that the total tax savings in return for a $50,000 investment would be $50,600 in 1983 and $25,000 in 1984.

None of the limited partnerships engaged or risked capital in the actual printing, manufacturing, or distribution of any books or software. Instead, the limited partnerships retained entities known as service contractors to perform these tasks and to bear the concomitant costs. Service agreements for the Properties were executed by the limited partnerships and the service contractors. These agreements were negotiated by Irving Cohen, usually in connection with the acquisition of the Properties covered by a particular service agreement. In fact, the service contractor for a particular Property was generally affiliated with the publisher from whom that Property had been purchased. Partially as a result of this connection between the selling publisher and the service contractor, the limited partnerships never obtained physical control over any of the Properties.

The service agreements specified both an "anticipated initial printing" and a "minimum additional printing(s)" for every Property. A service contractor was obligated to print, bind, and distribute the number of copies called for in the initial printing. If requested by the limited

partnership, the service contractor also had to make available additional copies up to the number specified by the minimum additional printing term of the agreement. Notably, the number of copies specified in the "minimum additional printing(s)" category, *i.e.*, the maximum number of copies the service contractor was obliged to print after the initial print order, bore no relationship to the number of copies from additional printings that Cohen and the publisher assumed would be printed when they negotiated the purchase price.

In return for this work, the service contractors collected fees from the limited partnerships–typically a portion of the sales price of each book or piece of software printed and distributed. However, the contractor received these fees only to the extent any books or software were actually sold. In addition, the contractors were reimbursed for printing, binding and distribution fees, but again only to the extent revenues actually were generated by the sale of books and software.

Chadwick acted as the placement agent for the limited partnerships and was thus responsible for finding sophisticated investors interested in participating in the tax shelter program. Chadwick received from the limited partnerships, in return for its efforts in selling partnership units, a sales commission of $5,000 per unit sold. Between thirty and forty partnership units were available in each of the ninety-five Barrister Equipment Associates limited partnerships, at a price of $50,000 per unit. This $50,000 payment was due in three installments over the course of two years–$5,000 at the closing, $20,000 sometime later in the year of the purchase, and $25,000 sometime during the year following the purchase. Barrister Associates, the general partner of the limited partnerships, invested $25,000 in each limited partnership and received a general partner's fee of approximately $62,500 from each.

3. *Procedural History*

In 1986, the IRS determined that the transactions described above constituted the promotion of an abusive tax shelter, in violation of I.R.C. § 6700, and assessed the following penalties against each of the appellants:

Barrister Associates	$ 5,306,000
Paul Belloff	$ 5,306,000
Chadwick (Parliament)	$ 5,211,000
Robert Gold	$ 5,306,000

Madison Library	$ 400,000
Universal Publishing	$ 5,399,811
Geoffrey Townsend	$ 2,739,013

At the same time, the IRS assessed a penalty of $3,687,000 against Irving Cohen. Cohen, as well as each of the appellants here, paid fifteen percent of the assessed penalties, thus staying further collection by the IRS. *See* I.R.C. § 6703(c). Soon thereafter, Gold, Belloff, Chadwick, and Barrister Associates together filed an action in the Eastern District of New York for a refund of their portion of the penalties paid to the IRS. *See Barrister Associates v. United States*, No. CV 87-0403 (E.D.N.Y. filed Feb. 13, 1987). Madison, Townsend, and Universal similarly filed for a refund; their actions were brought in the District of Nevada. *See Madison Library, Inc. v. United States*, No. CV-S-87-125 (D.Nev. filed Feb. 12, 1987); *Geoffrey Townsend, Ltd. v. United States*, No. CV-S-87-127 (D.Nev. filed Feb. 13, 1987); and *Universal Publishing Resources, Ltd. v. United States*, No. CV-S-87-126 (D.Nev. filed Feb. 12, 1987). Finally, Irving Cohen filed a suit for a refund in the Southern District of Florida. *See Cohen v. United States*, No. 87-0265-CIV (S.D.Fla. filed Feb. 13, 1987). In each of these suits, the government counterclaimed for the unpaid portions of the penalty. In August 1987, the Judicial Panel on Multidistrict Litigation transferred the three Nevada cases and the Florida suit to the Eastern District of New York for pretrial purposes.

Cohen, Barrister Associates, Parliament, Belloff, and Gold then moved for partial summary judgment, arguing that they were at least entitled to a partial refund because the IRS had erred in its computation of the penalty in the original assessment against them. Chief Judge Platt agreed and ordered the IRS to reassess the penalties. *In re Tax Refund Litigation*, 698 F.Supp. 439 (E.D.N.Y.1988). In July 1989, the IRS, in compliance with this ruling, assessed the following penalties against each of the appellants:

Barrister Associates	$ 534,693
Paul Belloff	$ 124,672
Chadwick (Parliament)	$ 1,446,713
Robert Gold	$ 124,672
Madison Library	$ 400,000
Universal Publishing	$ 8,994,367
Geoffrey Townsend	$ 4,395,925

The increase in the penalties against Universal and Townsend, who were not parties to the motion for partial summary judgment, resulted from a change in the method by which the government determined their gross income. *In re Tax Refund Litigation*, 766 F.Supp. at 1252.

In October 1989, the three Nevada actions, *Madison Library, Inc. v. United States, Geoffrey Townsend, Ltd., v. United States*, and *Universal Publishing Resources, Ltd. v. United States*, were, at the request of appellants, consolidated for trial in the Eastern District with the already-existing New York suit, *Barrister Associates v. United States*. Because of the government's opposition to consolidation, the Florida action, *Cohen v. United States*, was remanded to the Southern District of Florida for trial, although the remand and the trial were stayed pending the conclusion of the proceedings in the Eastern District. *In re Tax Refund Litigation*, 723 F.Supp. 922, 923 (E.D.N.Y. 1989).

The consolidated cases were tried during the late spring and early summer of 1990. The jury's responsibility was limited to determining whether any of the appellants had promoted an abusive tax shelter, as defined by I.R.C. § 6700, and whether any were thus liable to pay a penalty. The government was the defendant in this refund action, but, because it bore the burden of proof on liability, presented its main case first. In order to simplify matters, appellants agreed that six Barrister Equipment Associates limited partnerships (Series 115, 116, 117, 121, 123 and 126) would serve as representative of the scheme for purposes of the jury's verdict.

On July 11, 1990, the jury returned a special verdict, finding that appellants were liable for a Section 6700 penalty. Pursuant to an agreement between the parties, the district court then considered the amount of the penalty owed by each appellant. The court first held that the government's assessment was presumed to be valid, and that the appellants bore the burden of proving that the facts necessitated a reduction in that assessment. *In re Tax Refund Litigation*, 766, F.Supp. at 1253-55. Chief Judge Platt then ruled on each of the objections to the 1989 assessment and ordered the parties to submit detailed calculations of the penalties consistent with his rulings. *Id.* at 1255-65. On June 10, 1991, after receiving these calculations, the court entered judgment against the appellants for the following amounts:

Barrister Associates	$	534,692.50
Paul Belloff	$	9,667.00

Chadwick (Parliament)	$	1,446,712.50
Robert Gold	$	9,667.00
Madison Library	$	400,000.00
Universal Publishing	$	8,994,367.00
Geoffrey Townsend	$	4,395,925.00

Appellants' subsequent motions for judgment notwithstanding the verdict or for a new trial were denied without opinion in late September 1991. Appellants then brought this appeal from both the June 1991 judgment and the September 1991 denial of the post-judgment motions. The government cross-appealed from certain exclusions by Chief Judge Platt from the gross income base of the penalties assessed.

DISCUSSION

[1] Appellants attack both the jury's finding of liability[1] and the district court's calculation of the penalties. The government's cross appeal focuses solely on the penalty portion of the judgment. We turn first to appellants' challenges to the jury's verdict.

1. Appellants' Liability Under Section 6700

The version of Section 6700 of the Internal Revenue Code in effect at the time of the pertinent transactions imposed a penalty on:

> Any person who–
>
> (1)(A) organizes (or assists in the organization of)–
>
> (i) a partnership or other entity,
>
> (ii) any investment plan or arrangement, or
>
> (iii) any other plan or arrangement, or
>
> (B) participates in the sale of any interest in an entity or plan or arrangement referred to in subparagraph (A), and
>
> (2) makes or furnishes (in connection with such organization or

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[1]Appellants Barrister Associates, Chadwick, Belloff, Gold, Universal, and Townsend contend that the district court should have applied a three-year statute of limitation to the assessment of the penalties. *See* I.R.C. § 6501(a) ("Except as otherwise provided in this section, the amount of any tax imposed by this title shall be assessed within three years."); I.R.C. § 6671(a) ("penalties shall be assessed and collected in the same manner as taxes"). We recently rejected a similar contention in *Capozzi v. United States*, 980 F.2d 872 (2d Cir. 1992), and need not discuss it here.

sale)–

(A) a statement with respect to the allowability of any deduction or credit, the excludability of any income, or the securing of any other tax benefit by reason of holding an interest in the entity or participating in the plan or arrangement which the person knows or has reason to known [sic] is false or fraudulent as to any material matter, or

(B) a gross valuation overstatement as to any material matter. . . .
I.R.C. § 6700(a)

[2] The jury returned a special verdict, which found that appellants, in their organization and promotion of the representative Barrister Equipment Associates limited partnerships, had made: (i) gross valuation overstatements with regard to each of the Properties leased by the six representative limited partnerships and (ii) false or fraudulent statements with respect to tax benefits that might be available to those who purchased an interest in one of the limited partnerships. Appellants contest both findings. Before turning to the specifics of their arguments, we note that because the Section 6700 penalty applies to either gross valuation overstatements or false or fraudulent statements, the penalty must be affirmed unless we reverse both jury findings. Because we affirm the finding regarding gross valuation overstatements, we do not reach the jury's finding regarding false or fraudulent statements.

[3] A gross valuation overstatement is "any statement as to the value of any property or services if . . . the value so stated exceeds 200 percent of the amount determined to be the correct valuation." I.R.C. § 6700(b)(1). Whether such a gross valuation overstatement has been made is a question of fact upon which the government bears the burden of proof. I.R.C. § 6703(a). The government introduced at trial the reports and testimony of four different appraisers, who together valued the Properties leased by the six representative limited partnerships as worth considerably less than one-half of their declared values.

[4, 5] The value of a piece of property must be established in order to determine whether an individual has made a gross valuation overstatement with respect to that property. *See* I.R.C. § 6700(b)(1). Generally, the correct or fair market value of a good is defined as the price at which a willing buyer would purchase the good from a willing seller. *See, e.g., United States v. Cartwright*, 411 U.S. 546, 551, 93 S.Ct. 1713, 1716-17, 36 L.Ed.2d 528 (1973); 5 Boris I. Bittker, *Federal Taxation of Income, Estates and Gifts* ¶ 132.1.2 (1984). A price arrived

at through arm's length negotiations is usually the most reliable evidence of fair market value, *see* 5 *id.* at ¶ 132.2.1, although it is not invariably conclusive. It does not apply, for example, "where a transaction is based upon 'peculiar circumstances' which influence the purchaser to agree to a price in excess of the property's fair market value." *Bixby v. Commissioner*, 58 T.C. 757, 776 (1972) (citations omitted)

[6] Appellants argue that the purchase prices of the Properties were arrived at through arm's-length negotiations and that those prices reflected as a matter of law the fair market value of each of the Properties. Appellants suggest that the jury would have so concluded had not the government's appraisal evidence been admitted and that that evidence was inadmissible. Citing language in a recent decision–"purchase as a result of arm's-length bargaining fixes fair market value; appraisal testimony arguably irrelevant," *Jacobson v. Commissioner*, 915 F.2d 832, 838 (2d Cir. 1990)–appellants contend that appraisal evidence may not be admitted when there is proof of arm's-length bargaining. We disagree.

First, the purported quotation from *Jacobson* has been ripped from its context. The following is the relevant passage:

> As to the significance of a purchase price that approximates production cost, see *Evans [v. Commissioner]*, 908 F.2d [369,] 374 [(8th Cir.1990)]; *Siegel v. Commissioner*, 78 T.C. 659, 687-88 (1982); *Upham [v. Commissioner]*, 57 T.C.M. [(CCH) 508,] 510, 513 [(1988)]; *Vandenhoff [v. Commissioner]*, 53 T.C.M. [(CCH) 271,] 282 [(1987)]; *cf. Scheid v. Commissioner*, 50 T.C.M. (CCH) 663, 670 (1985) (*purchase as a result of arm's-length bargaining fixes fair market value; appraisal testimony arguably irrelevant*).

Jacobson, 915 F.2d at 838 (emphasis added). What appellants label in their brief as a "holding" of *Jacobson* is actually a parenthetical description of a decision of the Tax Court. Nothing in *Jacobson*, therefore, supports the contention that appraisal evidence is inadmissible when there is evidence of arm's-length bargaining.

Second, common sense dictates that a rule rejecting appraisal evidence in such circumstances would be undesirable. The pertinent valuation should, like any question of fact, be determined on all available evidence, including evidence of the nature of the negotiations and expert appraisal evidence. Both kinds of evidence are relevant to the disputed valuation, and each reflects upon the reliability of the other. Appraisal

evidence is thus relevant to whether the negotiations were truly arm's-length. If, after viewing all the evidence, including appraisal evidence, the trier determines that the negotiations were truly arm's-length and informed, it should accept the results of those negotiations as reflecting an accurate valuation. If it determines that the negotiations were not arm's-length and informed, then it may look to the appraisal evidence as evidence of value.

In the instant matter, the jury was free to find, and found, that the negotiations were not arm's-length. The special verdict sheet in the instant matter properly instructed the jury to consider whether there had been any gross valuation overstatements only after determining that the transactions were not at arm's-length. The jury thus specifically found that the purchases of the Properties were not the result of arm's-length negotiations. This finding followed logically from the totality of the evidence offered by the government, including the testimony and reports of the appraisers and the evidence concerning the various relationships and transactions.

An arm's-length transaction between a buyer and seller is one untainted by motives other than the desire of each to obtain the best price. The facts concerning this tax shelter, and inferences to be drawn from them, indicate that the purchases were dominated by other motives. Irving Cohen, in negotiating the purchase of the Properties, had strong incentives to agree to inflated prices in order to increase the tax benefits available to the limited partnerships. The acquisition agreement provided for small downpayments and relatively massive promissory notes. By labeling the notes recourse, Cohen insured that these debts would be included in computing the investment tax credit. In reality, however, the promissory notes were functionally identical to nonrecourse obligations. The Properties purchased with the notes were pledged as security but, until twelve years after their execution, no payments were due on the notes except to the extent the Properties purchased realized net revenues. At the end of twelve years, the publishers could look only to the corporate assets of Townsend and Universal to collect amounts still owed on the notes. A trier could thus easily find that by then the corporate cupboards would be bare.

By structuring the purchases of the Properties in this fashion, Cohen creates the appearance of substantial capital investments without a genuine risk of loss beyond the downpayments and the nonexistent assets

of Townsend and Universal. The notes thus look like nonrecourse debt. Once the transactions were so understood by the jury, its conclusion that Cohen wanted to inflate the size of the promissory obligations–the larger the obligation, the greater the resulting investment tax credit–was inexorable. And, of course, the publishers had no incentive to resist such arrangements. The acquisition agreements guaranteed that any net revenues realized through the sale of the works produced from the Properties would eventually flow to the publishers, either immediately, or through payments to the service contractors. The publishers thus had absolutely nothing to lose as a result of these agreements. In sum, the transactions here were based upon the sort of "peculiar circumstances" that defeat any presumption that the purchase prices reflected the fair market values of each of the Properties. *See Bixby* 58 T.C. at 775.

Alternatively, appellants contend that the actual appraisal reports and testimony were too subjective to be admissible. Once again, they look in vain to *Jacobson v. Commissioner* for support. In *Jacobson*, we reviewed a tax court decision that held, *inter alia*, that the acquisition of a movie by a limited Partnership was a sham transaction that should be ignored for federal tax purposes. We reversed because the decision was based in part on the tax court's own subjective evaluation of the potential profitability of the movie. We stated that "[w]e reject this judicial version of the Siskel and Ebert 'thumbs up, thumb down' approach to film evaluation. . . . [T]he court is not to reject profit motive because of subjective dislike of a film's style or disapproval of a film's theme. It is not for courts to predict what themes are geared to popular success." *Jacobson* 915 F.2d at 839.

However, the jury in the instant matter was charged with determining the market value of the Properties, not the price they would as individuals have paid for the Properties. Given the nature of the jury's task, the government's expert testimony was clearly admissible. *See* Fed.R.Evid. 702.

[7] Nor are we troubled by the fact that each of the appraisers' valuations of the Properties may contain an irreducible subjective element. The appraisal of any Property that does not have frequently traded identical substitutes will necessarily be guided by both objective and subjective considerations. The four government appraisers were qualified as experts, and their valuations were grounded on their experience in the publishing industry and on objective factors such as the

potential market for the book or software, the reputation of the author, and competition from other works. *See American Nat. Bank and Trust Co. v. K-Mart Corp.*, 717 F.2d 394, 399 (7th Cir.1983) ("Where ... testimony of a qualified witness as to the value of property has a reasonable factual basis, it should not be ... excluded."). Appellants had ample opportunity during cross-examination to explore any subjective considerations underlying the experts' appraisals and to cast doubt on the reliability of those appraisals. *See United States v. 0.161 Acres of Land*, 837 F.2d 1036, 1040 (11th Cir.1988). Appellants were also free to argue to the jury that the appraisers' valuations were inherently unreliable because of subjective considerations. Finally, appellants offered the opinions of their own expert, who testified that the purchase prices were reasonable. The jury, adequately instructed on the weight to accord expert testimony, was thus in a position to balance the competing opinions and to determine the actual values of the Properties on an informed basis.

2. Amount of the Penalty

Under the version of Section 6700 in effect at the time of the relevant transactions, a person found liable for organizing or promoting abusive tax shelters had to "pay a penalty equal to the greater of $1,000 or 10 percent of the gross income derived or to be derived by such person from such activity" I.R.C. § 6700. In determining the penalty owed by each appellant, Chief Judge Platt assigned appellants the burden of proving any error in the July 1989 assessments. *In re Tax Refund Litigation*, 766 F.Supp. at 1253-55. Chief Judge Platt considered appellants' numerous objections to the government's assessments, rejecting all but two objections raised by Belloff and Gold. All appellants except Madison, as well as the government, challenge his decision on a number of grounds.

a. *Assessment on an Annualized Basis*

Appellants Barrister Associates, Chadwick, Belloff, Gold, Universal, and Townsend argue that the government must assess the Section 6700 penalty with reference to a discrete taxable year and only on income actually earned during that year. For simplicity, we will examine the specifics of this argument with regard to Barrister Associates, although our conclusions apply to all appellants.

In its 1989 assessment against Barrister Associates, the government

allocated the $534,692.50 penalty between 1982 and 1983, with $215,255 assigned to 1982, and the remaining $319,437.50 to 1983. The portion of the penalty assessed for 1982 was based on all of the general partnership fees attributable to the thirty-five Barrister Equipment Associates limited partnerships promoted in 1982, regardless of whether those fees were actually received in 1982. The same method was used to compute the 1983 portion of the penalty. *See In re Tax Refund Litigation*, 766 F.Supp at 1258-59. However, when the district court entered its judgment, it simply found Barrister Associates liable for the entire $534,692.50, without reference to particular taxable years.

In assessing the penalty against Barrister Associates, the government assigned to a particular year all of the income attributable to the limited partnerships promoted during that year, whether or not the income was actually earned in that year. The district court approved this technique. *Id.* Barrister Associates argues that this violates I.R.C. § 6671(a), which provides that "penalties and liabilities provided by this subchapter [which includes I.R.C. § 6700] ... shall be assessed and collected in the same manner as taxes." Taxes, Barrister Associates correctly notes, are assessed annually, with reference to a particular calendar period. *Cf.* 26 C.F.R. § 301.6203-1 (1991) (summary record of tax assessment shall identify, *inter alia*, "the taxable period, if applicable"). Barrister Associates concludes that the Section 6700 penalty must also be assessed with reference to a taxable period.

In determining the penalty owed for 1982, Barrister Associates argues, the government should have looked only to the limited partnership fees (and other income) Barrister Associates actually received in 1982. Money earned in later years could be considered only when (and if) the government assessed a penalty for those years. Under the rule suggested by Barrister Associates, therefore, the government would have to divide a Section 6700 penalty assessment into discrete taxable periods, and, in computing the penalty for each period, consider only gross income actually earned during that period. We disagree.[2]

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[2]As a practical matter, the resolution of this issue might have no real effect except perhaps to complicate IRS efforts to penalize organizers and promoters of abusive tax shelters. No statute of limitation applies to the government's assessment of a Section 6700 penalty, *see supra* Note 1, and the government is thus free to assess a penalty against a promoter of an abusive tax shelter at any time.

If we agreed that an assessment may only be made with regard to income earned

[8] The plain language of the statute is contrary to Barrister Associates' argument. In enacting Section 6700, Congress expressly authorized the IRS to assess a penalty on future income, that is, on income "to be derived" from the promotion of an abusive tax shelter. I.R.C. § 6700; *see* S.Rep. No. 494, 97th Cong., 2d Sess. 248 (1982), *reprinted in* 1982 U.S.C.C.A.N. 781, 1015 ("In determining the penalty with respect to the amount of gross income *yet to be derived from an activity*, the Secretary may look only to unrealized amount which the promoter or other person may reasonably expect to realize.") (emphasis added). A holding that the government could assess a penalty only on income actually earned would disregard Congress's unambiguous direction that the penalty be imposed on future earnings. We cannot ignore their unambiguous language. *See, e.g., Connecticut Nat'l Bank v. Germain*, ___ U.S. ___, ___, 112 S.Ct. 1146, 1149, 117 L.Ed.2d 391 (1992).

The Internal Revenue Code thus does not obligate the IRS to assess Section 6700 penalties only on income actually earned during discrete taxable periods. Unlike the assessment of, for example, a tax deficiency, *see* I.R.C. §§ 6211-6216, which is directly tied to the payment of a particular tax owed in a particular taxable period, the assessment of a Section 6700 penalty turns on income earned from specific conduct–the organization or promotion of an abusive tax shelter–that may occur at times different from those in which income is actually realized. This is in contrast to other Internal Revenue Code penalties, which depend on whether, and how often, an individual avoids certain tax obligations arising in a particular taxable period. *See, e.g.*, I.R.C. § 6704 (civil penalty for failing to keep certain records; penalty "for any calendar year shall be $50, multiplied by the number of individuals with respect to whom such failure occurs in such year"); I.R.C. § 6723 (person who fails to include correct

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during a discrete taxable period, we would have to remand the instant matter with directions to eliminate from the penalties assessed amounts not attributable to money earned during 1982 or 1983. The government could then assess an additional penalty against Barrister Associates based on income earned after 1983. In the end, Barrister Associates might have to pay at least the same total penalty already reflected in the district court's judgment. In fact, because of a 1984 amendment to Section 6700, which increased the penalty to twenty percent of gross income, *see* Tax Reform Act of 1984, Pub.L. No. 98-369; § 143(a), 98 Stat. 494, 682 (1984); *see also Gang v. United States*, 783 F.Supp. 376, 379-81 (N.D.Ill.1992) (holding that twenty-percent penalty applies to all income earned after effective date of 1984 amendment), Barrister Associates could potentially be liable for a larger penalty than the one already assessed, depending on when it actually received its post-1983 income.

information on an information return shall pay a penalty for each failure). Other circuits have similarly found that Section 6700 penalties need not be assessed with reference to a discrete taxable period. *See Sage v. United States*, 908 F.2d 18, 22 (5th Cir.1990); *Planned Invs. Inc. v. United States*, 881 F.2d 340, 344 (6th Cir.1989); *Gates v. United States*, 874 F.2d 584, 588 (8th Cir.1989). *But see Bond v. United States*, 872 F.2d 898, 901 (9th Cir.1989) (dicta that Section 6700 penalties should be assessed on an annualized basis).

Barrister Associates argues, however, that, because the practical difficulties in assessing the penalty without reference to discrete taxable periods are so great, this construction of Section 6700 "reads [the section] out of the Internal Revenue Code." The argument underlying this bit of hyperbole is that: income, whether subject to a tax or a penalty, can only be measured by reference to some time period. If this "temporal dimension" is ignored, it becomes impossible to measure and tax or penalize income in any rational manner. The government thus collects taxes on an annual and retrospective basis because of the intractable problem of predicting with accuracy the individual future incomes of millions of taxpayers.

However, the instant matter raises issues of a less intractable dimension. For purposes of calculating a Section 6700 penalty, the government is concerned only with gross income to be derived from a particular, well-defined activity. With regard to such an activity, it is far less daunting to predict future earnings, at least those earnings that a person "may reasonably expect to realize." S.Rep. No. 494, 97th Cong., 2d Sess. 267, 1982 U.S.C.C.A.N. p. 1015. We therefore see no practical obstacles to assessing the penalty on income expected in later years.

b. *Inclusion of Earnings Expected but Never Received in Gross Income Base*

Barrister Associates argues that the district court should not have allowed the government to consider, in assessing the penalty against Barrister Associates, limited partners fees never actually paid to Barrister Associates by certain of the limited partnerships. Again, we disagree.

[9] Section 6700 allows the government to assess a penalty on "gross income derived or to be derived" from the tax shelter activity. As noted, this language contemplates assessments on earnings to be derived in the

future from the promotion of an abusive tax shelter. But "[i]n determining the penalty with respect to the amount of gross income yet to be derived from an activity, the [government] may look only to unrealized amounts which the promoter or other person may reasonably expect to realize." S.Rep. No. 494 at 267, 1982 U.S.C.C.A.N. at 1015.

In the instant matter, the only income Barrister Associates earned from the tax shelter promotion was the one-time general partner's fees owed it by each of the limited partnerships. With the exception of $28,750 still owed by three of the limited partnerships, Barrister Associates had received all of these fees by 1986. Thus, at issue is whether this $28,750 was unrealized income that Barrister Associates could have "reasonably expect[ed] to realize", when the government first assessed the penalty in 1986.[3] We believe that the answer is yes.

As the district court noted, at the time of the first assessment, Barrister Associates could have brought suit to recover the unpaid fees from the defaulting limited partnerships. While, with the benefit of hindsight, we now know (and indeed the government knew in 1989) that a

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[3] When the government first assessed a penalty on Barrister Associates in 1986, it assessed the penalty on a $1000 per each separate tax shelter transaction basis. In granting the motion for partial summary judgment, the district court held that this method was improper and that the $1000 penalty is to be used only when ten percent of the gross income from all transactions is less than $1000. *In re Tax Refund Litigation*, 698 F.Supp at 443. Because ten percent of Barrister Associates' income from the tax shelter promotion exceeded $1000, the district ordered the government to reassess the penalty using the gross income method. Thus, it was only in the subsequent 1989 assessment that Barrister Associates' gross income became relevant.

However, for purposes of determining the proper amount of that assessment, the government had to evaluate Barrister Associates' actual and expected gross income as if it were still 1986. In other words, in computing the penalty, the government could consider the full amount of any income already received as of 1986, and the 1986 present value of any income expected to be realized after 1986. This is because interest on the unpaid portion of the 1989 assessment accrued from the time of the first assessment in 1986, at least to the extent the amount of the 1989 assessment was less then or equal to the amount of the 1986 assessment. And, therefore, if the government were permitted to make its assessment using the full value of all income Barrister Associates realized as of 1989, and it were also allowed to calculate interest on this assessment from 1986, Barrister Associates would pay double interest on post–1986 income. Of course, to the extent any income actually received by 1989 could not have bee anticipated in 1986, the government could issue a new assessment against Barrister Associates, but interest would accrue only from the date of this new assessment.

lawsuit to recover those fees was necessary but never pursued, this fact does not make consideration of the $28,750 improper. The burden was on appellants to show that the fees would not have been recoverable through such a lawsuit. Absent such a showing, the government was entitled to take the $28,750 into account.

c. *Liability of Barrister Associates for Fees Received From Limited Partnerships of Which it was Not the General Partner*

Barrister Associates next contends that the penalty assessment should not have been based on $125,000 in general partner's fees attributed to Barrister Equipment Associates Series 122 and 129, because Barrister Associates was not the general partner of those two limited partnerships and thus did not receive income from them. According to Barrister Associates, another entity, Barrister Associates, Inc., which is not a party to the present action, acted as general partner of the two partnerships and received the general partner's fees from those limited partnerships. Thus, Barrister Associates concludes, the $125,000 in revenues should have been excluded from the assessment against it.

Because the district judge concluded that this issue related to the amount of the penalty, rather than to Barrister Associates' liability as a promoter of abusive tax shelters, he held that Barrister Associates bore the burden of proving that it did not receive the general partner's fees in question. *See In re Tax Refund Litigation*, 766 F.Supp. at 1259-60. Barrister Associates takes issue with this allocation of the burden of proof, and argues that, because this question concerns Barrister Associates' liability for organizing and promoting Barrister Equipment Associates Series 122 and 129 the government had to prove Barrister Associates received the pertinent general partner's fees by clear and convincing evidence.[4] We disagree.

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[4]No party challenges on appeal the district court allocation of the burdens of proof, *i.e.*, that the government had to prove liability by clear and convincing evidence and appellants had to prove the assessments were improper by a preponderance of the evidence. We express no opinion on whether this allocation was correct but note that other courts have held that the government need prove liability only by a preponderance of the evidence. *See Weir v. United States*, 716 F.Supp. 574, 577 (N.D.Ala.1989); *American Technology Resources v. United States*, 709 F.Supp. 610, 617 (E.D.Pa.1989), *aff'd*, 893 F.2d 651 (3rd Cir.), *cert. denied*, 495 U.S. 933, 110 S.Ct. 2176, 109 L.Ed.2d 505 (1990); *United States v. Music Masters Ltd*, 621 F.Supp. 1046, 1053-54 (W.D.N.C.1985),

[10] Had this matter been tried with regard to each limited partnership, we might well be inclined to find this issue to be one of liability rather than damages. However, under the procedural ground rules agreed to by the parties, the government had no obligation to prove that Barrister Associates, or any of the other appellants, had violated Section 6700 with respect to the organization and promotion of each of the ninety-five limited partnerships. Rather, the government had to show only that Barrister Associates had engaged in activities prohibited by Section 6700 with respect to any of the six representative limited partnerships, which did not include either Series 122 or 129. All remaining questions went to the size of the penalty, and the government was entitled to a presumption that its assessment of the penalties was correct. *See Welch v. Helvering*, 290 U.S. 111, 115, 54 S.Ct 8, 9, 78 L.Ed. 212 (1933). Barrister Associates thus had the burden of proving that it was not the general partner of Barrister Equipment Associates Series 122 and 129.

The district court found that Barrister Associates had not met this burden. *In re Tax Refund Litigation*, 766 F.Supp. at 1259-60. This finding was not clearly erroneous. *See* Fed.R.Civ.P. 52(b). Specifically, the court relied on Form 1065 partnership tax returns and the attached Schedules K-1 filed by the two limited partnerships for the fiscal years ending October 31, 1983 and October 31, 1984, that indicated that the general partner of the two limited partnerships was itself a partnership called either Barrister Associates or Barrister Associates, Inc. The court also relied on the fact the lease agreements and service agreements entered into by the two limited partnerships were signed "Paul Belloff, General Partner of Barrister Associates, the General Partner." *See In re Tax Refund Litigation*, 766 F.Supp. at 1259-60. Barrister Associates does not dispute the content of these documents but argues that they were not admitted into evidence. Again, we disagree.

Appellants signed a pretrial order stipulating to the authenticity of these documents and their admissibility, reserving only the right to object under Fed.R.Evid.403. Appellants do make an argument based on Rule 403, and we perceive no prejudice to appellants from Chief Judge Platt's deeming them to be part of the record.

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aff'd, 816 F.2d 674 (4th Cir.1987)

d. *Inclusion in Gross Income of Cost of Sales and Goods*

Chadwick argues that money it paid in commissions to sales representatives who sold interests in the limited partnerships should have been excluded from the gross income base of the penalty assessed against Chadwick. Similarly, Townsend and Universal contend that the cash portion of the purchase prices of the Properties should have been excluded from the gross income base of the penalties assessed against them. Their arguments are meritless.

[11, 12] Unless an exclusion is specifically provided, gross income is "all income from whatever source derived, including (but not limited to) the following items: (1) Compensation for services, including fees, commissions, and similar items; . . . (5) rents." I.R.C § 61(a). All of the income Chadwick derived from the tax shelter promotion was in the form of sales commissions from the limited partnerships, an item expressly included in gross income. Chadwick cites no Internal Revenue Code provision that authorizes an exclusion from gross income for commissions it paid to sales representatives. The district court thus did not err in failing to deduct from Chadwick's gross income base the amount of the commissions paid. As to Townsend and Universal, the income they derived from the tax shelter program was in the form of rent payments from the limited partnerships. Such payments are also expressly listed as a form of gross income. *Id.* Because the Internal Revenue Code does not provide an exclusion from gross income for the cost of leased goods, the district court correctly declined to grant a reduction equal to the cash downpayments made on the Properties from Townsend's and Universal's gross income.

e. *Imposition of a Penalty on Both a Partnership and its Partners*

[13] The district court excluded earnings Belloff and Gold had received from Barrister Associates from the gross income base of the assessments against them. *In re Tax Refund Litigation*, 766 F.Supp. at 1255-57. Chief Judge Platt reasoned that Belloff and Gold were the general partners of Barrister Associates, and they were personally liable under New York law for the Section 6700 penalty assessed against the partnership. N.Y. Partnership Law §§ 24, 26 (McKinney 1988). Moreover, Barrister Associates was liable for any penalty assessed against Belloff or Gold as a result of actions taken within the scope of their authority as general partners, including the promotion of the tax shelter

program at issue here. *Id.* Chief Judge Platt concluded that imposing a penalty on Belloff and Gold based on gross income they derived from Barrister Associates, and, at the same time, imposing a penalty on Barrister Associates based on that same income, would constitute a double tax not authorized by Congress. *See United States v. Hemme*, 476 U.S. 558, 572, 106 S.Ct. 2071, 2079, 90 L.Ed.2d 538 (1986) (double tax permissible only if clearly intended by Congress).

In its cross-appeal, the government argues that this was error. It points out that a Section 6700 penalty may be assessed against "any person" who promotes or organizes an abusive tax shelter. I.R.C. § 6700. A partnership and its individual partners are both persons for purposes of the Internal Revenue Code. See I.R.C. § 7701(a)(1) (definition of "person"). Had a non-partner of the partnership engaged in conduct within the scope of his or her authority that violated Section 6700, both the agent and the partnership could be penalized on any income earned as a result of that conduct. The government thus argues that, because the jury found that Gold, Belloff, and Barrister Associates had engaged in conduct subject to a penalty under Section 6700, all three should be held accountable to the full extent of any income derived from their tax shelter activity. The question is a close one, but we disagree.

The government's agent scenario is different from the situation here. It is true that an agent who promotes abusive tax shelters on behalf of a partnership is subject to a penalty based on the agent's earnings derived from that conduct, as is the partnership. Unlike the instant case, however, income to the partnership is not income to the agent, and an agent of the partnership has no obligation to pay the partnership's penalty. The agent is thus not double-taxed by a penalty. On the other hand, debts of the partnership are debts of the partners, and income to the partnership is income to the partners. Indeed, partnerships and individual proprietorships are generally not taxable entities, *see* I.R.C. § 701, presumably to avoid double taxation of owners who do not have unlimited liability. Absent a clear direction from the Congress, we follow that logic here and agree with Chief Judge Platt.[5]

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[5] The government also contrasts the instant situation with the case of a corporation and its culpable shareholders. Specifically, it points to the district court's ruling that Gold and Belloff were both liable to pay a penalty based on income each received from Chadwick, a subchapter S corporation, even though Chadwick was also liable for a penalty based in part on the same income. But again the government's argument fails to

f. *Transfer of Ownership of Chadwick*

[14] Finally, the government contends that the district court should not have excluded roughly $200,000 from the gross income base of the penalties assessed against Belloff and Gold. This was income each purportedly derived from Chadwick during 1984. Belloff and Gold were both one-third shareholders of Chadwick. At the end of 1983, after receiving notification that the government was investigating their activities and at the request of the third shareholder, Ronald Cohen, Belloff, and Gold transferred their interests in Chadwick to their respective wives. A portion of the sales commissions owed to Chadwick by the 1983 limited partnerships was not received until 1984, after the transfer. A portion of that 1984 income went to the wives of Belloff and Gold, namely in the form of cash withdrawals and Keogh Plan contributions. The district court held that this income, received by the wives of Belloff and Gold after the transfer, should not be included in the gross income base of the penalties assessed against Belloff and Gold. *In re Tax Refund Litigation*, 766 F.Supp. at 1258.

The government argues, however, that Belloff and Gold bore the burden of proving that the income in question was not expected to be derived by them and failed to carry that burden. We agree. Belloff and Gold were clearly trying to diminish the penalty by transferring their interest in Chadwick to their wives. We do not believe that this transfer, without more, demonstrates that their interest in the future income has in fact been eliminated, even assuming the doubtful proposition that a genuine transfer without consideration might be recognized for these purposes. Certainly, any other rule might vitiate the effect of the penalties intended by Congress.

Affirmed on the appeal; affirmed in part and reversed in part on the cross-appeal.

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recognize that the obligation to pay these penalties does not fall upon the same individuals. Chadwick bears no responsibility for penalties imposed on its shareholders, and, while the value of Belloff's and Gold's stock in Chadwick will undoubtedly diminish because of Chadwick's penalty, Belloff and Gold are not personally liable for that penalty.

APPENDIX B

EDNY
91-6289
PLATT

UNITED STATES COURT OF APPEALS
FOR THE
SECOND CIRCUIT

At a stated Term of the United States Court of Appeals for the Second Circuit, held at the United States Courthouse in the City of New York, on the 22nd day of March, one thousand nine hundred and ninety-three.

Present: HON. WILFRED FEINBERG,
HON. RALPH K. WINTER,
HON. FRANK X. ALTIMARI,

Circuit Judges.

IN RE: MDL-731 – TAX REFUND LITIGATION OF ORGANIZERS AND PROMOTERS OF INVESTMENT PLANS INVOLVING BOOK PROPERTIES LEASING

--------- ° ---------

BARRISTER ASSOCIATES, PAUL BELLOFF, PARLIAMENT SECURITIES CORP., ROBERT GOLD, MADISON LIBRARY, INC., UNIVERSAL PUBLISHING RESOURCES, LTD. and GEOFFREY TOWNSEND, LTD.,

Plaintiffs-Appellants-Cross-Appellees,

- v. -

UNITED STATES OF AMERICA,

Defendant-Appellee-Cross-Appellant.

Docket Nos.
91-6289
91-6291
91-6317

Appeal from the United States District Court for the Eastern District of New York.

Docket Nos. 91-6289; 91-6291; 91-6317

This cause came on to be heard on the transcript of record from the United States District Court for the Eastern District of New York and was argued by counsel.

ON CONSIDERATION WHEREOF, it is now hereby Ordered, Adjudged and Decreed that the judgment of said district court be and it hereby is affirmed on the appeal; affirmed in part and reversed in part on the cross-appeal in accordance with the opinion of this Court.

ELAINE B. GOLDSMITH, Clerk
By:

/s/ Edward J. Guardaro

Edward J. Guardaro
Staff Attorney

ISSUED AS MANDATE 6-7-93

APPENDIX C
UNITED STATES COURT OF APPEALS
FOR THE
SECOND CIRCUIT

At a stated term of the United States Court of Appeals for the Second Circuit, held at the United States Courthouse in the City of New York, on the 20th day of May, one thousand nine hundred and ninety-three.

IN RE: MDL-731 -- TAX REFUND LITIGATION
OF ORGANIZERS AND PROMOTERS OF INVESTMENT
PLANS INVOLVING BOOK PROPERTIES LEASING

BARRISTER ASSOCIATES, PAUL BELLOFF, PARLIAMENT SECURITIES CORP., ROBERT GOLD, MADISON LIBRARY, INC., UNIVERSAL PUBLISHING RESOURCES, LTD. AND GEOFFREY TOWNSEND, LTD.,

Plaintiffs-Appellants-Cross-Appellees,

V.

UNITED STATES OF AMERICA,

Defendant-Appellee-Cross-Appellant.

DOCKET NUMBER: 91-6289, 91-6291, 91-6317

A petition for rehearing containing a suggestion that the action be reheard in banc having been filed herein by counsel for appellant Madison Library, Inc., Universal Publishing Resources, Ltd., and Geoffrey Townsend, Ltd..

Upon consideration by the panel that decided the appeal, it is

Ordered that said petition for rehearing is DENIED.

It is further noted that the suggestion for rehearing in banc has been transmitted to the judges of the court in regular active service and to any other judge that heard the appeal and that no such judge has requested that a vote be taken thereon.

FOR THE COURT,
ELAINE B. GOLDSMITH, Clerk
By:
/s/ Carolyn Clark Campbell
Carolyn Clark Campbell
Chief Deputy Clerk

APPENDIX D

UNITED STATES DISTRICT COURT
EASTERN DISTRICT OF NEW YORK

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IN RE TAX REFUND LITIGATION MDL 87-731 (TCP)

JUDGMENT

---------- x

PLATT, Chief Judge

This action came before the Court for trial by jury. The issues have been tried, the jury has rendered its verdict, and the Court has issued its decision concerning the amount of the penalty.

Now, therefore, it is ordered and adjudged

that:

1) the defendant United States of America recover from the plaintiff Robert Gold an amount of $9,667.00, crediting all amounts previously paid or collected against this sum, plus statutory interest on unpaid balances from the date of assessment to the entry of judgment; plus interest thereafter according to law;

2) the defendant United States of America recover from the plaintiff Paul Belloff an amount of $9,667.00, crediting all amounts previously paid or collected against this sum, plus statutory interest on unpaid balances from the date of assessment to the entry of judgment, plus interest thereafter according to law;

3) the defendant United States of America recover from the plaintiff Barrister Associates an amount of $534,692.50, crediting all amounts previously paid or collected against this sum, plus statutory interest on unpaid balances from the date of assessment to the entry of judgment, plus interest thereafter according to law;

4) the defendant United States of America recover from the plaintiff Parliament Securities, Inc. an amount of $1,446,712.50, crediting all amounts previously paid or collected against this sum, plus statutory interest on unpaid balances from the date of assessment to the entry of judgment, plus interest thereafter according to law;

5) the defendant United States of America recover from the plaintiff Madison Library, Inc. an amount of $400,000.00, crediting all amounts previously paid or collected against this sum, plus statutory interest on unpaid balances from the date of assessment to the entry of judgment, plus interest thereafter according to law;

6) the defendant United States of America recover from the plaintiff Universal Publishing Resources, Inc. an amount of $8,994,367.00, crediting all amounts previously paid or collected against this sum, plus statutory interest on unpaid balances from the date of assessment to the entry of judgment, plus interest thereafter according to law;

7) the defendant United States of America recover from the plaintiff Geofffrey Townsend, Ltd. an amount of $4,395,925.00, crediting all amounts previously paid or collected against this sum, plus statutory interest on unpaid balances from the date of assessment to the entry of judgment, plus interest thereafter according to law.

SO ORDERED.

/s/ Thomas C. Platt
Chief Judge, U.S.D.C.

Dated: Uniondale, New York
May 31, 1991

APPENDIX E

UNITED STATES DISTRICT COURT
EASTERN DISTRICT OF NEW YORK

---------- x

IN RE TAX REFUND LITIGATION MDL 87-731 (TCP)

ORDER

---------- x

PLATT, Chief Judge.

Plaintiffs' Motions for Judgment Notwithstanding the Verdict or for a new trial are denied. No opinion.

SO ORDERED.

/s/ Thomas C. Platt
Chief Judge, U.S.D.C.

Dated: Uniondale, New York
September 19, 1991

UNITED STATES DISTRICT COURT
EASTERN DISTRICT OF NEW YORK

---------- x

UNIVERSAL PUBLISHING
RESOURCES, LTD.,

87 CV 2885 (TCP)

Plaintiff,

ORDER

-against-

UNITED STATES OF AMERICA,

Defendant.

---------- x

PLATT, Chief Judge.

Plaintiff's Motion for Judgment Notwithstanding the Verdict or for a new trial is denied. No opinion.

SO ORDERED.

/s/ Thomas C. Platt
Chief Judge, U.S.D.C.

Dated: Uniondale, New York
September 30, 1991

UNITED STATES DISTRICT COURT
EASTERN DISTRICT OF NEW YORK

---------- x

GEOFFREY TOWNSEND,

Plaintiff,

-against-

UNITED STATES OF AMERICA,

Defendant.

---------- x

87 CV 2886 (TCP)

ORDER

PLATT, Chief Judge.

Plaintiff's Motion for Judgment Notwithstanding the Verdict or for a new trial is denied. No opinion.

SO ORDERED.

/s/ Thomas C. Platt
Chief Judge, U.S.D.C.

Dated: Uniondale, New York
September 30, 1991

UNITED STATES DISTRICT COURT
EASTERN DISTRICT OF NEW YORK

---------- x

MADISON LIBRARY,

87 CV 2884 (TCP)

Plaintiff,

ORDER

-against-

UNITED STATES OF AMERICA,

Defendant.

---------- x

PLATT, Chief Judge.

Plaintiff's Motion for Judgment Notwithstanding the Verdict or for a new trial is denied. No opinion.

SO ORDERED.

/s/ Thomas C. Platt
Chief Judge, U.S.D.C.

Dated: Uniondale, New York
September 30, 1991

APPENDIX F

STATUTES[1]

I.R.C. § 38. Investment in certain depreciable property

(a) General rule. – There shall be allowed, as a credit against the tax imposed by this chapter, the amount determined under subpart B of this part.

I.R.C. § 46. Amount of credit

(a) General rule. . . .

(2) Amount of credit. –

(A) In general. The amount of the credit determined under this paragraph for the taxable year shall be an amount equal to the sum of the following percentages of the qualified investment (as determined under subsections (c) and (d)):

(i) the regular percentage,

(ii) in the case of energy property, the energy percentage,

(iii) the employee plan percentage, and

(iv) in the case of that portion of the basis of any property which is attributable to qualified rehabilitation expenditures, the rehabilitation percentage.

* * *

(c) Qualified investment. –

(1) In general. – For purposes of this subpart, the term "qualified investment" means, with respect to any taxable year, the aggregate of –

---

[1]These provisions are taken from the Code as it read in 1982 and 1983, the years in question in this case.

(A) the applicable percentage of the basis of each new section 38 property (as defined in section 48(b)) placed in service by the taxpayer during such taxable year, plus

(B) the applicable percentage of the cost of each used section 38 property (as defined in section 48(c)(1)) placed in service by the taxpayer during such taxable year.

I.R.C. § 48. Definitions; special rules

(a) Section 38 property. –

(1) In general. – Except as provided in this subsection, the term "section 38 property" means --

(A) tangible personal property (other than an air conditioning or heating unit), . . .

° ° °

(d) Certain leased property. –

(1) General Rule. – A person (other than a person referred to in section 46(e)(1)) who is a lessor of property may (at such time, in such manner, and subject to such conditions as are provided by regulations prescribed by the Secretary) elect with respect to any new section 38 property (other than property described in paragraph (4)) to treat the lessee as having acquired such property for an amount equal to –

(A) except as provided in subparagraph (B), the fair market value of such property, or

(B) if the property is leased by a corporation which is a component member of a controlled group (within the meaning of section 46(a)(6)) to another corporation which is a component member the same controlled group, the basis of such property to the lessor.

I.R.C. § 465. Deduction limited to amount at risk

(b) Amounts considered at risk -- . . .

(2) Borrowed amounts. -- For purposes of this section, a taxpayer shall be considered at risk with respect to amounts borrowed for use in an activity to the extent that he --

(A) is personally liable for the repayment of such amounts, or

(B) has pledged property, other than property used in such activity, as security for such borrowed amount (to the extent of the net fair market value of the taxpayer's interest in such property).

No property shall be taken into account as security if such property is directly or indirectly financed by indebtedness which is secured by property described in paragraph (1).

I.R.C. § 1012. Basis of property -- cost

The basis of property shall be the cost of such property, except as otherwise provided in this subchapter and subchapters C (relating to corporate distributions and adjustments), K (relating to partners and partnerships), and P (relating to capital gains and losses). The cost of real property shall not include any amount in respect of real property taxes which are treated under section 164(d) as imposed on the taxpayer.

I.R.C. § 6671. Rules for application of assessment penalties

(a) Penalty assessed as tax. -- The penalties and liabilities provided by this subchapter shall be paid upon notice and demand by the Secretary, and shall be assessed and collected in the same manner as taxes. Except as otherwise provided, any reference in this title to "tax" imposed by this title shall be deemed also to refer to the penalties and liabilities provided by this subchapter.

I.R.C. § 6700. Promoting abusive tax shelters, etc.

(a) Imposition of penalty. -- Any person who --

(1) (A) organizes (or assists in the organization of) --

(i) a partnership or other entity,

(ii) any investment plan or arrangement, or

(iii) any other plan or arrangement, or

(B) participates in the sale of any interest in an entity or plan or arrangement referred to in subparagraph (A), and

(2) makes or furnishes (in connection with such organization or sale) –

(A) a statement with respect to the allocability of any deduction or credit, the excludability of any income, or the securing of any other tax benefit by reason of holding an interest in the entity or participating in the plan or arrangement which the person knows or has reason to know is false or fraudulent as to any material matter, or

(B) a gross valuation overstatement as to any material matter,

shall pay a penalty equal to the greater of $1000 or 10 percent of the gross income derived or to be derived by such person from such activity.

(b) Rules relating to penalty for gross valuation overstatements. --

(1) Gross valuation overstatement defined. -- For purposes of this section, the term "gross valuation overstatement" means any statement as to the value of any property or services if --

(A) the value so stated exceeds 200 percent of the amount determined to be the correct valuation, and

(B) the value of such property or services is directly related to the amount of any deduction or credit allowable under chapter 1 to any participant.

(2) Authority to waive. -- The Secretary may waive all or any part of the penalty provided by subsection (a) with respect to any gross valuation overstatement on a showing that there was a reasonable basis for the valuation and that such valuation was made in good faith.

(c) Penalty in addition to other penalties. -- The penalty imposed by this section shall be in addition to any other penalty provided by law.

I.R.C. § 6703. Rules applicable to penalties under sections 6700, 6701, and 6702.

(a) Burden of proof. -- In any proceeding involving the issue of whether or not any person is liable for a penalty under section 6700, 6701, or 6702, the burden of proof with respect to such issue shall be on the Secretary.

(b) Deficiency procedures not to apply. -- Subchapter B of chapter 63 (relating to deficiency procedures) shall not apply with respect to the assessment or collection of the penalties provided by sections 6700, 6701, and 6702.

(c) Extension of period of collection where person pays 15 percent of penalty. –

(1) In general. – If, within 30 days after the day on which notice and demand of any penalty under section 6700, 6701, or 6702 is made against any person, such person pays an amount which is not less than 15 percent of the amount of such penalty and files a claim for refund of the amount so paid, no levy or proceeding in court for the collection of the remainder of such penalty shall be made, begun, or prosecuted until the final resolution of a proceeding begun as provided in paragraph (2). Notwithstanding the provisions of section 7421(a), the beginning of such proceeding or levy during the time such probation is in force may be enjoined by a proceeding in the proper court.

(2) Person must bring suit in district court to determine his liability for penalty. – If, within 30 days after the day on which his claim for refund of any partial payment of any penalty under section 6700, 6701, or 6702 is denied (or, if earlier, within 30 days after the expiration of 6 months after the day on which he filed the claim for refund), the person fails to begin a proceeding in the appropriate United States district court for the determination of his liability for such penalty, paragraph (1) shall cease to apply with respect to such penalty, effective on the day following the close of the applicable 30-day period referred to in this paragraph.

(3) Suspension of running of period of limitations on collection. -- The running of the period of limitations provided in section 6502 on the collection by levy or by a proceeding in court in respect of any penalty described in paragraph (1) shall be suspended for the period during which

the Secretary is prohibited from collection by levy or a proceeding in court.

APPENDIX G

FEDERAL RULES OF EVIDENCE

Rule 401. Definition of "Relevant Evidence"

"Relevant evidence" means evidence having any tendency to make the existence of any fact that is of consequence to the determination of the action more probable or less probable than it would be without the evidence.

Rule 702. Testimony by Experts

If scientific, technical, or other specialized knowledge will assist the trier of fact to understand the evidence or to determine a fact in issue, a witness qualified as an expert by knowledge, skill, experience, training, or education, may testify thereto in the form of an opinion or otherwise.

APPENDIX H

For the Defendant:

Department of Justice
Tax Division
Washington, D.C. 20001
BY: DENNIS DONOHUE
HAROLD SKLAR
Special Litigation Counselor

Court Reporter:

Joseph Barbella
U.S. District Court
Uniondale Ave. at Hempstead Tpke.
Uniondale, New York 11553
(516) 485-6559

Proceedings recorded by mechanical stenography, transcript produced by computer-aided transcription.

THE COURT: I guess we are ready and the jury is ready. You might as well bring them in.

MR. KOHANE: Your Honor, this is the retyped proposed charge that the parties have agreed on.

THE COURT: All right.

(Jury enters jury box.)

THE COURT: Good morning, laides and gentlemen.

The parties have agreed upon the following instructions on the tax question or tax law that they asked me to give you prior to the first witness' testimony. It reads as follows:

The investment tax credit is computed as a percentage of the acquisition costs of property, which qualifies for the

A No. They told me to be as generous or as liberal as possible.

Q In analyzing those books did you follow through with those instructions?

A Yes, I did.

Q Thank you.

Q Now turning to the Classics of the Silent Screen, what kind of book is that?

A This is basically a guy who is it on television here in New York and was for many years, named Joe Franklin, who specialized in nostalgia, specifically about the silent screen area. He was on television in the 1950's and at 1:30 in the morning now. It reviews silent screen classics and tells about the stars. The book was initially published in 1959.

Q Did you review an author contract?

A Yes, I did.

Q And what date is reflected therein?

A It was dated in 1958, December 16th, 1958, between Serial Press and Joe Franklin, William K. Everson E V E R S O N, and John E. Allen, A L L E N.

Q And were you also given what we have been referring to as an acquisition agreement between Universal and the publisher Lyle Stuart?

A Yes, I was.

Q And what date is that?

A May 26, 1983.

Q And in 1983 they were purchasing a 1958 book?

A So it would appear.

Q And what is your analysis of that book?

A In terms of the market for this book I would think it would be seriously diminished by 1983 for a number of reasons.

Q And what are they?

A First of all, just looking at the number of people who would be interested in the silent films would be diminished seriously by the death rate between 1959 and 1983.

Joe Franklin dropped this nostalgic bit in terms of silent screen stuff largely from his program as time went on for that obvious reasons. If you look at the content of this book, by 1983 content was considerably out of date. For example, in his biographies of people like Charley Chaplin, he is referred to in the present tense as he is still alive. But Chaplin died I think in 1977.

There is an actress Leatrice Joy, J O Y, and if I may read one passage from Mr. Franklin's work, Leatrice still makes an occasional movie just for the fun of it, but there haven't been more than a handful over the past 25 years. The last was one of Marilyn Monroe's early 20th Century Fox comedies, Love Nest. Ms. Joy still respects and loves the silent cinema too much to want to become a very active part of talkies and is quite content in Connecticut as one of Greenwich's glamorous grandmothers.

In 1983 she was about 90 years old.

Q Was there any talk about an update between 1958 and 1983?

A None whatsoever.

Q Any attempts?

A None whatsoever.

Q Was that the same book published in 1958?

A Yes. It has the same ISBN International Standard Book Number.

Q That's another term we will come to use in the ensuing weeks, what is the International Standard Book Number?

A Each book the publisher publishes is supposed to be coded by a number issued by the ISBN agencies, which in his country, R.R. Bowker Company, B O W K E R, Company, and in each case that number is supposed to be totally unique to the book. Mere reprints of the book are not supposed to have a changed ISBN number. You have to actually make significant changes in the book so it is a genuinely new edition in order to legitimately give it a new ISBN N, because it is a standard number used throughout the industry that designates a book.

Q How were you able to determine that the ISBN number on this 1983 volume was the same as on the 1958 edition?

MR. RITHOLZ: Objection, relevancy, your Honor.

THE COURT: How was he able to determine? I don't know. I think that's relevant.

Were you able to determine?

THE WITNESS: I wasn't able to determine it was the same on the 58 edition, but I was able to determine it was the same of books in print in 1977 and 1978, the same as the book that I examined.

Q And is books in print a standard reference tool?

A Yes.

Q And would it have been available to anyone, including the purchasers of these volumes, this volume in 1983?

A It's found in all public libraries.

Q And how many copies of this 1958 slash '83 book did you acticipate would be sold?

A I figured the maximum sales would be 12,500 copies, again over a five year period.

Q And did you subject this to the traditional analysis that you subjected the previous book?

A Yes, I did.

Q And what was your analysis?

A Well, as I said before, I thought the markets for a book on silent screen stars would be seriously diminished because of the number of people still alive who had been witnesses to the silent screen was diminished. And moreover the book was out for many years and whatever market there would have been out for such a book in my view would have been largely saturated by the time 1983, '84 rolled around.

Q Would you agree, nor does it with any well grounded interest in old things?

A I think that's too sweeping to respond.

Q Some things don't interest you; as a result?

A An old orange doesn't interest me.

Q What about an old subject like silent movies?

A It has very little interest to me.

Q To you, I thought so.

Indeed when you stated all the things in this report, you are stating your opinion?

A No, sir, I am not. I am stating my opinion –

Q Is it not your opinion that this book has a diminished audience and is not of interest?

A Yes. And it is an opinion ground on facts.

Q Yes, we all see our opinion as ground on fact, don't we?

A No doubt.

Q And on page 3 you mention a number of things that you would want to do and one of them is to determine how many potential customers exist.

A That's not quite what I said here.

Q How many potential customers –

A May I read the sentence that precedes that?

Q No. You get that on redirect. I am asking the questions.

Is point one, how many potential customers exist for the work based on interest the subject matter and in the

A Yes. The AB scenes, this one from Dr. Schank. It purports to teach the alphabet to children.

Q One second, I don't want them to be left behind, AB scenes, which is the property, is 1M of series 115, the property itself was 114.01M, and your appraisal is 201.01M.

Q Go ahead.

A This is an odd one. If you are going to teach the alphabet to people I propose that that means that they are just learning the letters and, therefore, they can't read by definition. Yet this asks little children to spell which seems to me to be odd. I would imagine kids would be very frustrated if they got that far with it. This would fail any test with a reading teacher. It would be thrown out of any evaluation committee within minutes. It is really disgraceful. It is not an educational school at all.

Q Are they required to spell, to give commands?

A Spell a word, like pencil, a two syllable word. If you are going to spell a word give the children a break and have monosyllabic words. They might have looked at the Dolch (ph) list, which is a list of the words that kids recognize the sound of before they have learned to read. They might have taken a look at that. And the common practice, anyone with children know that it is a lot easier to teach a kid a word he has heard or she has heard before.

If you say "dog" the child knows what dog is, and then

Q – other than the down payment no payment for the balance was required until 1985 – 1995, except out of the proceeds of properties actually sold, published and sold?

A No.

Q You were not.

And still with the IPM PC 123 –

A Yes.

Q – which we talked about quite a bit – I would like you – to ask you, if you can tell me, who the distributor for this work was?

A Putnam.

Q Putnam. Is he one of the largest and most important book distributors in the United States?

A Important publisher.

Q And Putnam Publishing Group?

A Yes.

Q The distributors of this group?

A Yes.

Q And are they the very significant and important factor in the publishing industry in the United States?

A Yes.

Q No fly by nights; is that correct?

A No fly by nights.

Q Okay.

If I were to find the cash management book, was that

distributed by Putnam also?

A I have to look to refresh my memory. You are talking about the Holland book; is that right?

THE COURT: That's the profit and the cash flow; is that right?

Q Here you are.

(Handed to the witness.)

A Let me see the back. Thank you.

This is distributed by Putnam as well.

Q Putnam?

A Yes.

Q And incidentally, do you have – withdrawn. Saving time.

You also prepared for the government and it is referred to here, Exhibit 969, which is a combined summary evaluation?

A Yes.

Q Of the separate individual evaluations; is that right?

A That's true.

Q And in that you talk about, as of 1982 and 1983, you talk about the Electronics Publishing Industry?

A Yes.

Q Do you remember?

A Yes.

Q And that is the subject of most of it, you would agree?

A Yes.

there any other difference in those two books?

A The binding is different and has a different name on it. The jacket is different. It not only has a different name, but they left the title – different quality paper, too.

Q If you can, give us another title of a book which you have put within the category of a different book.

A The Flying Devis of Dunhuang.

Q Tell us your analysis of that book?

A I thought that you can stretch and maybe sell 300 copies of it.

Q And why was this in the category of a different book?

A Well, this book has few problems. Not only has the substituted pasted in title page, but it is not even pasted in evenly. It is lopsided and off center and would very easily be seen by a buyer. And art book buyers do carefully screen everything. The bibliographic references are important.

Q What is the price of that book?

A This price was priced at $85. I did some research on it and discovered some interesting things. It says published in 1983 by Alpine Fine Art Productions. And when I read the reference telling me what a Flying Devis was.

Q Pray tell, what is it?

A A mythical feature and these are paintings from China, and if you have seen them all, you have seen one, you see them all.

The back of the book had something in 1980 in

Fiction, most of the time, unless the author's name is so important and it carries it, but science, fiction, science fiction, and it makes the sale more attractive a package. Specifically at the time of purchase, I would say the jacket or cover is a sales poster, an advertising poster and, therefore, its appearance is very important.

Q Give us a book you appraised that had no four color art.

A This Worstward Ho, W O R S T W A R D.

Q The partnership number for this book is 115. It is 02L in that partnership. And the exhibit number is 114-02L.

Tell us what your analysis of this book was, Mrs. Mosesson.

A This book has a jacket that really says to potential buyers, Samuel Beckett, the title means nothing, and the black and white skimpy art has to be looked at several times in order to be interpreted.

When the reader opens the book and there is no art on the back either as specified.

When the reader opens the book, it is compounded to very large type blown up to almost 18 point. It looks very much like a children's book. And a reader in a book store would be able to flip through it and see prose, a place like none. A time when try see. Try say –

Q Read slower and start all over again.

A A place where none. A time where try see. Try say. How

small. How vast. How if not boundless bounded. Whence the dim. Not now. Know better now. Unknow better now. Know only no out of. No knowing how know only no out of. Into only. Hence another. And this is the whole book.

MR. SILVERSTEIN: Does it relate to four color art you were describing?

A No.

MR. RITHOLZ: I demonstrate it a know nothing demonstration of ignorance about one of the leaders of 20th century authors, Samuel Beckett.

THE COURT: The jury is not misled, they understand what she was reading and who it was written by I hope.

Q You heard counsel's objection, when you analyzed this book and determined its value, did you take into account the author of this book?

A I certainly did.

Q Did that effect the determination of the value of this book? If so, tell us.

A I would give it zero, because anybody picking it up and flipping through it in a book store which is what people do and looking at that would have put it down. Because of Beckett's name and he is a preeminent 20th century author, I figured, well, some libraries would buy it, some people who are collectors of everything by Beckett would buy it, and I gave it 2,000 copies.

Q Now let me direct your attention to – before I do that –

THE COURT: You are trying to tell us that the four colors would improve Beckett's image?

THE WITNESS: I think it might have been more attractive?

THE COURT: Is that what you are saying to us?

A – if the jacket or the cover gave some hint –

THE COURT: Do you think a little color would improve Beckett's image?

THE WITNESS: I don't know that it would. But it might improve the image of this particular Beckett book.

Q Were there other books that you appraised that had no four color art?

A Yes.

Q And in those books you appraised, in your opinion did it affect the volume of sales of the book?

A Yes.

Q The absence of four color arts?

A Yes.

Q Let me drag your attention to a transparency which would have your value of Worstward Ho.

There is a misprint on here, Mrs. Mosesson. It says westward, but the title of the book is actually Worstward.

A Yes. Worstward.

Q What is your value of this book?

A $3,291.

Q What was the value placed on the book by Universal?

A $325,000.

Q And how many copies again did you say this book would sell?

A I thought you could move 2,000 copies.

Q And how many books total were represented that would be printed of this book?

A 205,000 copies.

Q All right.

Now what was your next category?

A Time limit on publication rights.

Q And what do you mean by that?

A I meant – I mean that I read the agreement under which the publisher acquired the books, either from the authors or from other publishers, that there were restrictions on how long the publishers themselves could retain publishing rights to the books.

Q How did you determine that?

A I read the author agreements.

Q How would that effect the sales of a particular book?

A Well, if you had a time limitation where you could only sell the book say for three years, or two years, or until a certain number of copies had been sold or something like that, it would mean that you had a cut off, a limit to how long you

A Yes.

Q That's what I want to know, if you can see it. Remember it.

You think that looks like the one on the next page from cave 15 of the Yulangratoes (ph)?

A No.

Q Seriously, they are fascinating pictures, aren't they?

A That's a very subjective thing.

Q Thank you. You have made my point.

I was a little confused when you were testifying about this book. You said you saw another edition of it, was that it?

A No. I said it was listed in Books In Print.

Q Another edition was listed in Books In Print?

A I said there was an edition attributed to China books listed in Books In Prints.

Q Of the Devis of Dunhuang?

A Yes. The identical title and author.

Q Right. But you did not see that book?

A No.

Q Physically in your hand did you hold it?

A Physically I did not.

Q So, it is not possible for you to compare the binding, the paper, the intensity of color, the typeface, et cetera, is there?

this book is just short enough for a reader in a bookstore –

Q Excuse me, you said enough.

A I am not going to quote anymore. It says it all.

Q Now you go in comment. It is this appraiser's opinion that there are not five people in the United States who really understand Beckett's message in this book and that in fact Beckett may be putting his audience on. If the book had any sales at all it would be principally because of his name. But anyone picking it up in a bookstore could read it in about five minutes, and is doubtful that it would be a purchase except as a joke. To repeat, this appraiser thinks it is, underscored, a joke.

A Yes.

Q Is that what you would call an objective determination of anticipated sales?

A This appraiser says, yes.

Q That's an objective determination – now, what did you do to arrive at the notion first – are you suggesting maybe it should not be published at all?

A I am suggesting that this book would be bought as I have already said, by a Beckett fan, by somebody required to buy it, or as a joke.

Q But –

A A a joke, yes.

Q Are you suggesting it has no value other than a joke?

A I am suggesting it has a value perhaps in a collection of Beckett's works. I do not believe this would march out of a bookstore. It my be required reading in a college course as Mr. Ritholz has suggested, for some specific purpose. But it is just short enough and the type is just big enough for a reader in a bookstore to pick it up, to see what it is, and to give it as a put on.

Q But your appraisal didn't describe what else it might be good for except possibly five readers that might be interested in this book?

A Yes, who are not required to buy it, yes.

Q That's your –

A Five readers who aren't required to buy it to buy it, yes.

Q Now, I want to get into Shakespeare for a moment. And I am talking now about the Love Poems of Shakespeare and the negative of the Love Poems of Shakespeare is that there are hundreds of editions – it is also a pretty ugly looking book.

Q Initially you did say that.

MR. RITHOLZ: Hold it up. May I see it?

THE WITNESS: The interior art is attractive. The cover is not.

Q Is it two color?

A Yes. Not four color.

Q Should Shakespeare be in four color to sell?

A I think the color combination is not a smash. I don't

think it is especially a pretty jacket cover.

Q And that's the kind of thing you need to sell Shakespeare, a pretty cover?

A Well, if you have a lot of competition, Mr. Silverstein, I think you have to doll up the package a little bit and I don't call this dolled up package.

Q You think you must doll up Shakespeare to sell it?

A I think there are prettier editions. Otherwise why bother to print with any art in it if you don't need to doll it up.

Q That's a decision made by the publisher?

A This was, too.

Q I am saying that's a decision made by the publisher who apparently has determined that another edition of Love Poems of Shakespeare in that form might sell?

A Well, this was a publisher who had an author agreement who said I Morris Syrkin, S Y R K I N, or words to that effect, and am the copyright owner of all the Love Poems of Shakespeare.

Q You got a charge on the Citadel claiming a copyright. Are you suggesting Citadel in claiming the copyright is claiming ownership in Shakespeare poetry? Is that what you are suggesting?

A It is what the piece of paper said. It said I Morris Syrkin am the copyright owner. It says copyright 1963 by the Citadel Press.

Q Are you suggesting that that means that he is claiming

knowing what the market is.

Q What does that mean?

A Well, Citadel is the pale back imprint or a subdivision of Lyle Stuart. Lyle Stuart is not known for publishing classics or anything like that. Lyle Stuart is the publisher of sensuous woman, gambling books, sex books. It is not known for things like this and it doesn't market into this kind of a market.

Q What percentage of the total markets would Citadel therefore have?

A Infinitesimally small.

Q And what is that market?

A If it is infinitesimally small, it is almost not measurable.

Q Maybe, but give me some idea how you arrived at the figure of anticipated sales?

A I told you I was generous, I don't think they could even sell the 5,000 copies I posited for this book.

Q I will say that your generosity is a conclusion you got to. I don't know how you got there and I am trying to find out how you got to the numbers other than your own personal feeling without a crystal ball.

A I got to my numbers by having been in this industry for 43 years, by looking at overall statistics, by reading Publisher's Weekly, by having vibes of what is going on, by knowing Lyle

Stuart, by knowing bookstores don't carry books like this, by knowing that college and high school curricula don't buy from a publisher like Lyle Stuart, that this book would probably not be carried even in a college bookstore, and with a shortage of shelf space they wouldn't be here either, shelf space in most bookstores. And it wouldn't be there either. It is a special marketing.

As I indicated Citadel is not a firm that has a lot of shelf space in bookstores to begin with and it doesn't market to college so where does it sell.

Q Have you determined objectively, given numbers objectively to what you finally came to in your determination that this has X number of books anticipated sales?

Now, you are talking about a lot of theory, a lot of things that go into a pot, but please give me a number for all those various things that will then result in the number you came to.

A Based on some experience in selling reprint rights, yes.

Q Is there a number?

A Yes.

Q And do you have such a number for this particular appraisal?

A I don't have a number. I have my experience that tells me what you can reasonably anticipate a book that has the competition of four or five of Books In Print of Shakespeare's

offerings. That's only the ones in Books in Print. How about the ones sold on the street and –

Q How many are sold? Let's start with something.

A Many are sold, but there is enormous competition.

Q But few are chosen. Many are sold but few are chosen, I guess.

THE COURT: I get the impression you don't like green and yellow?

THE WITNESS: No, I love green and yellow. I have done many things in it.

THE COURT: I have a difficult time without these pads which are green and yellow.

THE WITNESS: It is love poems –

THE COURT: You didn't listen. I have a difficult time without these pads, which are green and yellow. Do you ever use yellow pads?

THE WITNESS: Sure all the time. I have one here.

THE COURT: I thought maybe it was because of color.

THE WITNESS: No.

Q You had another notion you introduced when you came to kit five, learning games. Do you remember that?

A Yes.

Q And you held up that little plastic thing that you thought might be sold in supermarket.

That's it. 99 cents.

A Yes.

Q And you gave it I think little or no value.

One of the things that you said about is is that there are individual items such as that.

Who would paper 99 cents for an individual item, four or five or six of them when they can get a whole book for $4.95; do you remember that?

A Yes.

Q And who would by Hamlet or Othello or As You Like It, or Macbeth, if they can get all of Shakespeare's tragedies in one volume? Who would do that?

A It wasn't just the four or five things. It was this highly unattractive front cover.

Q I am not talking about the cover now. I am talking about the notion you introduced which said essentially as I recall, we have individual items, and a number of individual items sold individually will cost more than a composite in one book, and apparently all these are in one book.

Is that a valid notion?

A Yes.

Q You think that someone might not want to spend 99 cents for a particular item rather than carry a book around or that someone might not want to have a particular play without carrying the whole volume of plays around?

A You are comparing Shakespeare with this, for a short span

of thing – concerned – a concerned parent will not buy something for kit five, six to twelve months –

Q Once again, a concerned parent will not buy.

Now, I have to ask you how you come to that conclusion.

A As a concerned parent of five children I come to that conclusion.

Q Of what you would buy?

A Concerned parents buy Spock. They buy Gizzel (ph). They by Ilg (ph). Concerned parents are not focussed on one tiny little aspect of a child's development. They buy the works. Because even an unconcerned parent has an idea that the kid doesn't stay from birth to three month indefinitely. There is a later stage.

Q This is a supermarket?

A Yes.

Q And going down the supermarket line there are lots of things that concerned parents or unconcerned parents or children might buy. And some may be worthy or unworthy, but they are available for sale.

I am trying to determine how you determine because it is a single item that that parent or that person should know that they could find that single item and four others like it in a volume sold someone else, is somehow going to affect the sale of that.

A Mr. Silverstein, it is not the only facts that that made me consider –

Q It is the only fact I am talking about right now.

A I think it is an unattractive package, half visible –

Q Mrs. Mosesson –

A I think if this is displayed on a counter with the entire series there the parent will see that he has to buy or she has to buy six things, not one thing, in order to get a full story, and will hesitate about spending 99 cents on four cards and not turn his attention to the multiplicity of other books found in the supermarket like the Better Homes and Gardens child and baby care. So I don't think this will sell.

Q I am aware that you don't think it will sell. I am trying to determine your objectivity and the basis on which you make that appraisal. That's all I am suggesting, that you are basing it on you as a concerned parent would not buy it.

A No, I am basing it on me as a consumer and on me as a publisher.

Q But on you?

A That's right.

Q I have one other item to go over with you.

Mr. Ritholz described the July 31, 1989 appraisal, the original appraisal you did and subsequently revised in February of 1990, I believe.

A Yes.

level was less than $276,742?

A Yes.

Q It was $200,555.

Then a day or two ago, once again you made an adjustment at the partnership level, and you determined that the value at the partnership level was – as I said, a few days ago you made a revision once again in partnership 116, and you determined that the value of the partnership level was $99,665.

A Where is that?

Q The attorneys for the government furnished to me this the other day, and I assume that this is your work that they furnished to me. I assume that's your handwriting.

A That's my handwriting.

Q So, let's see how this works.

For this particular partnership, you start with 276,000 on July 31st, and 742. And we revised it to 200,555 and we revised it a few days ago to $99,655, I believe it is.

The different methodology as you would call it?

A Yes.

Q All right.

But all of them rely on anticipated sales?

A Yes.

Q And the question is the objectivity of anticipated sales? And in the final analysis it is whether or not your anticipated

sales were objectively arrived at; is that true?

A They were professionally arrived at.

MR. SILVERSTEIN: Thank you. No further questions.

THE COURT: I think we will take a mid-morning recess, Mr. Donohue.

Ladies and gentlemen do not discuss the case.

(Whereupon, at this time the jury left the courtroom.)

(Whereupon, a recess is taken.)

7,500, something like that. And it was tough I remember him saying. It is in the report here.

I said thank you very much. It was that kind of a thing.

Where there were clearly completing books or a book, an apple to go with an apple instead of an orange.

Q You hit the nail on the head. I was wondering, is it in the report, I didn't see that?

A Yes, it is.

Q You don't recall it? I don't want you to take the time to look now.

A There is a report, look for Little Brown and Roger Donald.

Q Did you do that a lot?

A No.

Q Once in a while?

A Once in a while.

Q Okay.

Isn't it a fact, especially as an editor, you can go into a book and there is a real reason for expecting a successful result and sometimes you don't expect a great deal from a book and it does very well, or you are expecting a great deal and it doesn't do well?

A Yes.

Q And I heard someone say the publishing business is like drilling for oil, you lose a lot of times and sometimes you hit

it?

A Right, right.

Q And would you think the book for which you are justly well-known, Jaws for example, did you figure that that book would sell, even after a movie, and I think that went in 7 figures, didn't it? Jaws?

A You say it. Which edition.

Q Generally?

A The paper back was the 16th most successful paper back ever published.

Q How many copies would that be? Guess.

A Probably eight or nine million copies.

Q You didn't figure that when you had lunch with that fellow Benchley, did you?

A No. But that tingle was authentic. It was the real zap and it doesn't always work as you say.

Q If anyone says that this book would sell eight or nine million paper backs, you would say go on?

A I would have taken it under advisement.

Q And similarly Garden of Stone, you wouldn't have the same reaction about that book?

A I wouldn't have a zap on that book. It was a sort of dull thud for me. Your point.

Q Right.

On the other hand people could be surprised in this

300 percent?

A Yes.

Q Just briefly on Oriental Carpets without turning to it would you consider the vogue that Oriental Carpets has been having throughout the 80's that reasonable people might differ whether the market was 8,500 for such an excellent carpet book?

A Reasonable people might differ.

Q Thank you.

As to 123 03, would you agree that Louis L'Amour is one of the outstanding, one of the outstandingly successful mass market paper back writers for the last 40 years now?

A Yes.

Q Now, if you think it is not – it is not a bit affirmity, and it is perfectly understandable that a publisher – that a publisher might buy this early book of short stories of Louis L'Amour thinking he might make out pretty well with it? Do you think it is something a publisher might think?

A Do I think it is something a publisher might think?

I guess people are capable of thinking almost anything.

Q No, I don't want you to get off that way, can you tell me what a publisher would think, I can get this where I can put it out and maybe a lot of his fans of which there are many, many, might buy this book?

A His main line publisher wouldn't, because this book would

THE COURT: Is that better?

THE WITNESS: A little more comfortable, I feel a little low down, though.

MR. DRISCOLL: May I hand up my copy?

MR. DONOHUE: That's not your copy, that is the only copy.

THE COURT: We are dealing with one copy? The government is too cheap to make another copy?

MR. DONOHUE: No, your Honor, it is not a question of being cheap. I asked for counsel to give me a copy and I got it a few moments ago.

THE COURT: Which counsel?

MR. DONOHUE: Counsel who represents Mr. Gallen. And he is in the courtroom today.

THE COURT: Let's see it before you start passing it around.

(Handed to the Court.)

THE COURT: Show him these two documents pertaining to 1982 and 1983, and proceed from there. We will hold on to these others in view of what I just said. Let's get down to the meat and potatoes there.

MR. DONOHUE: You took the one with the number.

THE COURT: This is 1021.

Q I will hand you a document which represents two pages of an exhibit which has been marked as 1021.

(Handed to the witness.)

Q Sir, are those the publishers you represented in the years 1982 and 1983?

A Yes, they are.

Q All right.

Now, before I continue, you mentioned that you – that your company, Richard Gallen and Company it was a company that sold book properties to a Cohen entity; is that correct?

A Yes.

Q Now, did your company also serve as a service contractor?

A Confucian Press served as a service contractor.

Q When did Confucian Press begin to serve as a service contractor?

A I am not sure of the exact year. Whenever the Cohen entities required a service contractor to be part of the transaction Confucian Press served as the service contractor for my company and some others of the companies that I represented.

Q All right.

In 1982 and 1983 was Confucian Press serving as a service contractor?

A Yes.

Q All right.

Now, what was your role – I am going to turn actually to not your role as – your involvement as a service

CROSS-EXAMINATION
BY MR. DRISCOLL:

Q You still want to stand?

A Still want to stand.

Q Okay.

Amongst the various hats you have worn so far in your life, you have been an attorney and a publisher; is that correct?

A Yes.

Q Am I correct, Mr. Gallen, that you negotiated for the sale of certain book properties to an associate of Mr. Cohen's named Marvin Rosenbaum?

A Yes.

Q And you also negotiated with Mr. Cohen; am I correct?

A Yes.

Q Where did you go to college?

A Yale.

Q Where did you go to law school?

A Yale.

Q And you were representing yourself and your publishers on one side of the table when you negotiated this contract; is that correct?

A Yes.

Q And who was on the other side of the table?

A Mr. Cohen, Mr. Rosenbaum and they had their own attorneys.

Q Do you know what arm's length negotiations are?

A Yes.

Q Did you have a number of negotiations with Mr. Cohen?

A Yes.

Q Were these arm's length negotiations?

A Yes.

Q Were these arm's length negotiations?

MR. DONOHUE: Objection, calling for a conclusion of law.

THE COURT: You had your share this morning.

I will let him testify to that. He is an attorney. This is his opinion and he has been in this type of business for a number of years, and I think he is entitled to give his opinion on it.

I will caution you, ladies and gentlemen that question ultimately will be one of the questions for you to determine. But I will let him give his opinion as to whether it was an arm's length negotiation in his view.

A Yes, they were.

Q As you look back in 1982 and 1983 you vigorously represented your clients and those people you were acting on behalf of?

A I did.

Q From your point of view, your observations with Mr. Cohen and Mr. Rosenbaum, were they representing their interests

vigorously?

A Yes.

Q And they were trying to get the best price they could?

A Yes.

Q And you were trying to get the best price you could for your side?

A Yes.

Q And you had adverse interests at that time?

A Yes.

Q Am I correct also and Mr. Donohue went through this briefly, but in terms of negotiating with the Cohen interest – let me call it the Cohen interest to make it very simple – that you were obliged on behalf of yourself and the other publishers to make available to them the whole line of books that you had, it was thrown into the pot for negotiation?

A You mean by that each publisher I represented the Cohen organization wanted the right to pick and choose for any and all books that each publisher published, the answer is yes.

Q No little fiction where you can hide your best books for yourself?

A No. They wanted the pick of the list.

Q The pick of the litter.

You talked – am I correct that Cohen wanted to give you – I will drop the Cohen entity, I will say Cohen, that's what we are here about, that Cohen wanted to give you the least

THE COURT: Yes.

RECROSS-EXAMINATION
BY MR. SILVERSTEIN:

Q I have one area, Mr. Gallen.

I think you were cut off by Mr. Donohue when you started to describe the purchase price in the notes and the recourse – in the recourse data. Could you please describe that. When he said that that amount was inserted by the Cohen group you then responded to that in a way and you were cut off. Can you respond to that, please.

A Well, the purchase price was a product of negotiations that had taken place before any single book was purchased by the Cohen organization. Because the contract that we had to sign if we wished to do busines with the Cohen organization placed certain contractual obligations on us, we wanted to be in a position to not only recover our costs – let me once again go over those obligations, all the costs of publishing was ours, that's number one.

If we simply took the cash down payment and that was the end, we would lose money on the deal. There was no percentage in doing that. There was no percentage given the small amount of the cash down payment and the fact the recourse note was twelve years off, they – that couldn't help us pay anything. So we were willing to – unwilling to give our full

Q And was he a publisher that Irving Cohen did business with?

A Yes, he did a lot of business with him.

Q Did you ask Mr. Cohen if you could speak to these people, or did you ask him to arrange it, or how did it come about?

A No, we told him we would like to speak to certain publishers. He said these he felt were the key people that he was going to be doing business with.

And he'd tell us the next time when they were going to be in his office, you know, we could meet with them.

Q Then you met with Mr. Zacharius?

A We met with Mr. Zacharius shortly thereafter.

Q What did you ask him then?

A Similar questions.

Q And received what kind of answers?

A Well, he said the books would have been published if Irving was not involved in the picture. He said he would not have accepted a lower purchase price based on the terms of their agreement.

He said as far as the negotiations were concerned that Irving was so difficult to deal with, that he had terrible problems doing business with him.

And then he gave us the whole speech about how much Irving was doing for the publishing industry, that his money that he was providing was one of the items that was saving the publishing industry.

Q Sir, with respect to your acquisition, your purchase of book properties from Price Stern and Sloan –

A Yes.

Q – would Price – with Price, Stern, Sloan, you mentioned Mr. Sloan wanted to keep control of the book for a period of twelve years?

A We ultimately negotiated to that number. He actually requested a higher number.

Q A higher number, but you settled on twelve years?

A Yes, that's true.

Q And by control what did you mean by that?

A He wanted a purchase price such that the substantial percentage of revenues of the next twelve years of sales, which he estimated for us in most instances that he would keep that amount of money. And then after that we would own the properties out right.

Q Now, this would require then to pay off the note that you entered in with him, a multiple of the initial printing?

A Yes.

Q And what kind of multiple with Mr. Sloan are we talking about?

A When I first met with Mr. Sloan he indicated to me as a normal modus operandi he would print his books once a year and very often twice a year. In order to keep his inventories down he would prefer to print a little less so that he wouldn't get

caught with any cash flow problems, but in fact he would go back to press regularly annually, that's the normal way he did his business.

Q My question is what type of multiple with Mr. Sloan were you discussing with him?

A I have to suggest to you that he had asked for a 20 year – a 20 times multiple of initial print when we started negotiations. He wanted to be protected for twenty years on the cash flow. And we ultimately negotiated that twelve years was all we could do.

So the purchase price he asked for final; he made an offer he predicted or based on the amount of money he said he would like to receive over twelve years. And we negotiated that down a bit on the offers we made back.

Q What kinds of multiple are we talking about?

A I believe all of his numbers would have had to – we agreed to buy all of his books at a multiple at something less than twelve years. For some reason ten years sticks in my head.

Q Are we talking about ten years times the initial printing?

A I believe so.

Q So, it would have been necessary to pay off the note to have a multiple of approximately somewhere in the neighborhood of ten times the initial printing?

A That's correct.

into these acquisition agreements?

A Yes.

Q Were you aware that the higher the note, and I am talking about the note that you entered into with the publishers, the greater your purchase price?

A Yes.

Q What incentive did you have to keep the amount of the notes, the notes, plural, down?

A Because I tried to buy as many as twice – I tried to buy twice as many of these very same books for the same amount of money and was turned down. I wanted very much to own books for the lowest possible price with the same amount of cash if I could get it.

Unfortunately, I could not get it.

Q You entered into separate negotiations with the publishers for the cash part of the purchase price; is that correct?

A That was one of the factors.

Q Correct.

A Part of the negotiations including that.

Q And you wanted to pay the least amount of cash possible?

A Absolutely.

Q And on the notes, sir, and my question deals with the note.

What difference to you did it make if the note was $100,000, a million dollars or two million dollars, what

difference did it make to you?

A I hope it is obvious that I wanted to own these properties and pay it off out of the income stream. And the note could only be a reflection of the likely revenues to be produced from the future sales of books.

Q You set up a corporation each year in 1981, 1982, 1983?

A Yes, I did.

Q You load up these three companies, 1981, 1982, with a massive amount of liabilities; is that correct?

A Yes.

Q And you take out money in the form of loans from these companies; is that correct?

A I did do some of that.

MR. DONOHUE: Your Honor, I have nothing further.

CROSS-EXAMINATION
BY MR. SILVERSTEIN:

Q Mr. Cohen, I would like to stay on that last topic about the investment tax credit and the amounts of the notes related to it.

If I heard your testimony, you said you would have liked to have bought price the amount of books for the same price; is that correct?

A I would have liked to have bought even more than that for the same price.

Q So as far as the price is concerned you would get the same investment tax credit if you had 40 books or 80 books or 100 books for the same amount of money?

A Yes. And it would have been easier to pay off the notes as well.

Q So, there is real negotiations with respect to each one of these properties related to the potential because sales were going to pay off the notes, and if you had more sales because you had more books that would have been to your advantage, would it not?

A Yes.

Q Although the ITC would have been the same?

A Yes, absolutely, sure.

Q I would like to go back to 1981 with you, at the time when you had invited Mr. Gold and Mr. Belloff to be general partners of the Barrister programs.

You heard some testimony, and I believe you were here when Mr. Gold and Mr. Belloff were testifying about their conversations with you?

A Yes, I was here.

Q And I would like to confirm some of the things that were said to them, and the information that you furnished to them, I guess for them to consider before they would decide whether they wanted to be general partners.

Did you in fact outline the program to them as you

Q I am not sure what cherry pick means.

Let me ask you this question: Before acquiring a property didn't you have appraisers make a determination of whether the purchase price that you were paying for that property was reasonable and would result – could reasonably result in profit?

A Absolutely.

Q So that if they didn't come in with that result, would you buy that book?

A No.

Q And were you required to buy that book from the publisher?

A No.

Q And what is the notion of cherry pick? I don't think I understand that.

A If an appraiser – and this did happen on any number of occasions – if an appraiser indicated to me that he thought that the proposed acquisition price which resulted from the negotiation was too high, he would indicate to me that he would – he thought it should be renegotiated.

If in fact he didn't like the book for some reason and shared the reason with me, and told me not to buy it, I would pass that information along to the publisher and say that this is a book that we don't want to own.

But the intention was –

Q Let me just interrupt you for a moment.

MR. DONOHUE: I think his question was what do attorneys and accountants do in their practice.

MR. DRISCOLL: I am asking for this experience since this is a traditional vehicle of investors using in the United States, and their advisors, attorneys and accountants –

THE COURT: If you say one of the traditional I will buy it. Of course, the corporate vehicle is also a limited liability. But it is one of the traditional, right?

THE WITNESS: Yes, I would agree with that, yes.

Q In terms of the limited partnership there were – provided by Congress there are substantial tax advantages in not investing through a traditional corporation; is that correct?

A That's absolutely true.

Q Now, Mr. Donohue asked you a lot of questions about making small cash payments and larger notes. Do you recall all those questions?

A Yes.

Q Why not pay for all of these books entirely in cash?

A It would have been bad business for one and I couldn't afford it, for two.

Q The fact is that you basically used – purchased these books through a leveraged purchase?

A That is correct.

Q And one of the things you negotiated for was a pay out of the purchase price over a number of years; is that correct?

A Yes.

Q Was this something unique in the book – when you entered into these purchases with the publishers?

A It was a unique concept with the publishers. Back in the early years, of course by '83 I had already done business with some of them.

THE COURT: Wait a second.

It is a leveraged purchase, which was not unique in 1982 or 1983.

THE WITNESS: That's also true. I meant the actual buying of their physical property in this manner.

But, no, leveraged purchases were very prevalent in a wide variety of industries. As a matter of fact a number of publishing companies were actually acquired in leveraged purchases.

Q Had you had any experience in purchasing for yourself personally anything with a smaller cash payment and a larger note later on?

A I had a number of very pleasant experiences. I bought a business many years ago and I had to put down about ten percent of the purchase price and pay off the balance over a period of years. I bought equipment for the business and did relatively similar things. As a matter of fact the first house I ever bought, the first building I ever bought were purchased under very similar methods. I remember when I bought the house, I

MR. DRISCOLL: Book 19, and 115.

Q Do you remember testifying directly about that book?

A Yes.

Q And you testified about your negotiations with Mr. Gallen. And this is a mass market paper back. Am I correct?

A Yes, it is.

Q And what is the cover price of this book?

A $3.50.

Q All right.

Now, am I correct that in the Gallen books the net back to the publisher is only 40 percent of the retail price; is that correct?

A That's correct.

Q So, in this book, after it sold in a rack in an airport or bookstore or pharmacy, wherever it sold, out there before it gets back to us, it goes for $3.50 but we only get $1.40 back on it; is that correct?

A Yes.

Q If Gallen sold you that book that's all he would have gotten back?

A That's it.

Q So let's just start here if we can.

What do you call that, the net?

A Net sales.

Q Net sale price?

A Yes.

Q All right.

Now, Mr. Gallen insisted that before he would agree to sell this book to you, that he wanted to participate in the profits of this book?

A That is correct.

In this case the book, in this particular case he represented his client Pinnacle.

Q Pinnacle was one of the publishers he represented, but he negotiated this deal for Pinnacle?

A That is correct.

Q And he said to you, I am not going to give up these soft cover paper backs, including this one, unless I get the income stream from multiple printings?

A Absolutely.

Q Okay.

You entered into an agreement with him reflected in the acquisition agreement?

A Yes.

Q And that acquisition agreement he received virtually the entire income stream from the first printing; is that correct?

A Yes, that's true.

Q All right.

The initial printing on this book was I believe 125,000 copies?

A That is correct.

Q So, if my math is correct, it is going to take us down, the first printing of this book if it sells out is going to generate $175,000; is that correct?

A Yes.

Q 125,000 times $1.40.

A Yes.

Q If I remember Mr. Gallen's testimony, he also insisted on – and your testimony also – insisted on the income stream from additional printings?

A That's correct.

Q But, he is no longer going to get the line share or most of the income stream from that $1.40, is he?

A He would get most. He would get 60 percent.

Q And the balance would go to the service contractors or the partnerships?

A Yes.

Q 20 percent to the partnerships?

A 22.

Q 22.

But Gallen, or Pinnacle in this case would only get 60 percent?

A That's correct.

Q So, if my math is correct, 60 percent of $1.40 is 84 cents; is that correct?

A Yes.

Q Point 84.

Now, he told you that he is not going to give it up until he gets the income stream out of seven additional printers; is that correct?

A That's correct.

Q So, if the first printing is 125,000 copies, seven additional printings would be 875,000 copies; is that correct?

A Yes.

Q All right.

Q So, if Gallen's wish or requests or desires were achieved, he would get $735,000 out of the additional printing; is that correct?

What you did is multiply 84 cents times 875,000 copies?

A Yes.

Q And that's 735?

A Yes.

Q I hope my math is correct.

So, what Gallen has said to you when you apply his formula –

A Well, it is that number plus the other number.

Q Right. He gets virtually 100 percent of the first sale and then he gets 60 percent of the subsequent printings, so it would be 735, plus 175, which comes out to be about $910,000?

A That's what he wanted for the book.

Q In your conversations over the years with Gallen, this is what he wanted?

A Yes.

Q And he would give you the information and you knew in applying his formula what he wanted was $910,000?

A That's what he would ask for.

Q And you would do these calculations?

A Yes.

Q And if you recall what did you actually pay for the Oklahomans?

A 850,000.

Q How did you arrive at 850,000 if he wanted 910,000?

A I wanted to get it a little lower, if he could work with it, we had negotiated the cash portions somewhat strenuously and I asked him to make a concession on the total purchase price and he agreed.

Q What was the number again you paid for this one?

A 850,000.

Q You paid a cash component?

A Yes.

Q And then you had an agreement to pay him out someplace down the road, ten years, twelve years later?

A Twelve years.

Q And the fact that you didn't have to pay the money out for

down. Do you recall that?

A I heard that statement.

Q Let me ask you, the price for this book is 650, Omni, am I correct if you paid 650 for all these books you would have gotten exactly the same investment tax credit?

A Absolutely.

Q There was no motivation for you to increase the price from one book over another book?

A Exactly the opposite. I wanted to pay as little as I could, and buy as many books with as little cash as I could.

Q And Mr. Zacharious wouldn't give it to you cheaper?

A He would not.

Q If you had some kind of deal with it you could have got all this for $650,000 and gotten the same exact investment tax credit?

A That's correct.

MR. DRISCOLL: I can stop. Do you want me to continue, your Honor?

THE COURT: No, I think I will let them go.

Keith modified the views a little bit, he said we can start 9:15 or 9:30. So we will keep him happy and say 9:30. Don't discuss the case. And have a good evening.

(Case on trial adjourned until 9:15 clock, Thursday, June 14, 1990.)

Q A little bit. And I think that's where we left off yesterday and I will get back to that.

We did calculations based on Zacharius and Gallen, your conversations and discussions and discussions about purchasing?

A Yes.

Q And if I understood your testimony on the mass market paper backs you got a slightly better deal as a result of your negotiation with Zacharius?

A Yes.

Q Did you go back to Gallen and say I am getting the mass market paper backs from Zacharius at a price cheaper than you are willing to give it to me?

A Yes.

Q What did he say? What was the conversation?

A I called Richard and I said, Dick, quite frankly, I think you are charging me more than other people in the industry are charging me and I would like to renegotiate some of the areas with you.

He said we have already renegotiated it and he said these are the prices I must have or you are not going to buy these books.

Q He turned you down?

A He turned me down.

Q And you are right we were talking about Price Stern and

A In many instances they didn't know each other.

Q And when you negotiated figuratively you sat on opposite sides of the table?

A Yes.

Q And each negotiation was different?

A Yes.

Q And let's talk about Lyle Stuart. I think Blackstone got a lot of play in this case, so let's pick this one.

MR. DRISCOLL: May I approach the witness, your Honor?

(Counsel, approaches the witness stand.)

Q Blackstone's tricks anyone can do.

Why don't you tell us who the publisher of that was?

A Lyle Stuart, but it has the Citadel Press imprint, which is his company.

Q You bought this book and paid 157,000 for it. You agreed to pay 157,000 over the lifetime of I think it is twelve years pursuant to acquisition agreement. How much did you pay down in cash? I think it is $3,000?

A About $3,000 or so. A little over 3,000, 3,500. Let's called it 3,000.

Q And let's take a look at the acquisition agreement of that book, and I think Mrs. Mosesson made a big deal about this book and its prior history.

Take a look inside at the copyright page.

A Yes.

Q What does that say?

A Copyright, 1983, by Walter Gibson.

Q So, if you want to see what you bought, let's go back to the acquisition agreement, and 128.09, and it is dated 26th of May, 1983.

Normally, how did you buy books from Lyle Stuart? What was the negotiation for this book, how much did it come – how did it come about?

A He would tell me how much he wanted for the book.

Q This is different from Gallen?

A Yes.

Q And then what happened?

A I told him I needed a lot more information than that, and I would ask him what the title was, the author, his initial printing, the cover price, how many books he estimated to print additionally above that. And he would provide me with all that information in helping me consider whether I was willing to entertain his offer.

Q In this particular book did he disclose to you what the history of that book was?

A No, he did not.

Q Well, take a look here. What were you buying from him?

A I was buying a brand new paper back edition of the book.

Q You knew you weren't getting the hard cover edition of

that book?

A That's correct.

Q And it was spelled out in the acquisition agreement; is that correct?

A Yes.

Q And that you understood?

A Yes.

Q Why did you agree to pay 157,000 for Mr. Blackstone's Tricks?

A I thought this was the kind of book and kind of genre that never goes out of style. I thought it was an attractive book. I didn't see the back. I had the film. But the concept of a Blackstone book with magic tricks that anyone can do, I felt it could remain on the shelves well beyond the twelve years I needed to pay for it. And I expected to fully pay for it from the sales and I would own a very valuable piece of property for many years to come.

Q Was that the procedure that was followed in an effort to sell the book properties to you?

A Yes.

Q And you would review his request and get back to him?

A Yes.

Q And if he came up with the price you reflected it in the acquisition agreement and along with the other terms in the contract?

A Yes.

Q And unlike Mr. Sloan, Mr. Stewart here indicated all you are getting is the paper back edition?

A In this particular work, yes.

Q Every one is different.

A Yes.

Q Now, Stewart Tabori and Chang, you said you only bought new stuff from him?

A Yes.

Q And that's not one of the situations where we are talking about buying a Shakespeare or perhaps a Blackstone published previously in hard cover?

A That is correct. This would have been an original work.

Q I think in this trial, Dumont's Guide to Ireland is a Sturt Tabori and Chang book.

Do you want to check that for me.
(Handed to the witness.)

A Yes, it is.

Q Do you have a formula for that book?

A No.

All the Stewart Tabori and Chang books were negotiated on a book by book basis.

Q You would offer him a price and he would counteroffer and vice versa?

A Yes, vice versa. In Andy Stuart's case he would tell us

how much he would be willing to sell the book for.

I would ask him questions substantially similar to that I asked of Lyle Stuart, and that is to ask the information about the total print, the cover price, and the estimate of what he would print for a total of years, and perhaps a brief synopsis, a treatment, information on the title, the author. As much information as I can get in order to evaluate to make an offer on the book.

Q Each offer is made separately?

A Yes.

Q And you did your analysis and got back with your response?

A Yes.

Q And that's different than Gallen?

A Yes. A substantial difference.

Q I think this book and you have been criticized for the fact – I think they opened it up to the back of the book – Mr. Donohue is the "they" – and had any number of folks read from it, and at least this bottom line was read.

What does it say?

A The book was printed and bound by Novagraf S A in Madrid.

Q And that's right in the book?

A Yes.

Q And for everybody to see?

A Yes.

Q And read the line above it, I don't know if it was read

initial printing is given to you, and I say once you have a cash down payment, I asked you, how did you arrive at the purchase price? Do you remember me asking that question?

A Yes.

Q And you gave two different answers to that, I remember exactly what you said.

MR. DRISCOLL: Objection, your Honor.

THE COURT: Strike it out.

Q I thought you said –

THE COURT: Strike it out. You can't testify unless you take an oath.

It is up to the jury to determine whether he gave different answers and certainly not you.

Q Mr. Cohen, do you remember your answer to that question?

A Yes, I thought I clarified it and I thought the same thing was said. I can clear it up now.

Q What do you remember saying?

A That Mr. Gallen always insisted on receiving one hundred percent of the net sales revenues on the first printing and wanted a continued participation in the future sales, and he received 50 percent of all the net sales for the next seven printings, or at least that's the price he was hoping to achieve. And I would always translate that mathematically into a dollar number and offer something a little less.

Q If you recall, I just said to you that that really is a

A It says copies returned in that column. That column has to be the actual return that this would have been applied against that title, the books apparently which have come back.

Q Is that an actual number? Does that purport to be an actual number?

A Looking at this table I would say it is.

Q The next column is entitled what?

A Net copies sold.

Q Now, as of this time, what does net copies sold referred to as reported by distributors and publishers?

A Well, that is still – this is not a final one, this title, so it probably has what I would call reserve for additional returns. The distributors obviously don't want to pay publishers for books that are going to come back. So they generally reserve for returns. And this is a lower number than the difference between copies, distributed –

Q Are you able to do any kind of calculation or projection based on the report, or that column of figures, net copies sold?

A You could project but it isn't real until all the returns all come in. You couldn't.

Q You are familiar with the appraisal work done by the government appraisors in this case; is that correct?

A Yes.

Q In this case, assuming that the government appraisers,

their projected sales were accurate, would the publishers have made a profit in this case?

A Most – no.

Q When you were appraising books for Universal what did you appraise?

A I appraised the properties, the contracts, the properties in the sense that Universal was presented – had presented them. The copy that described the books, the service contract, the purchase agreement, stats of jackets, that kind of material. I have been over it many times.

Q And you didn't have the books?

A No, there were no books.

Q When you appraised for Moseley what did you appraise?

A I appraised books where they gave it to me, publishers, an author's contract. That's all I had.

Q When you appraised the several books that Mr. Donohue has identified as Troubador books, the company being acquired by PSS, did you have the acquisition agreements by Universal?

A No.

Q Did you have any agreements between Universal and Price Stern Sloan?

A No.

Q Did you have any publishing agreements at all?

MR. DONOHUE: Objection, your Honor. Leading.

THE COURT: Those are not leading questions. You can

This was again significant to me, because he said that the down payment was very crucial in my judgment – this is Mr. Cohen speaking to me – because I did not want to give any publisher more money than he had in hard dollars for bringing that book up to the point where he was going to publish it.

Because if I gave him back his money he would or could lose interests in the sales or promotions of the book.

So, I wanted to give as little as I could, certainly not more than 20, 25 or 30 percent of the amount the publisher invested in that book.

That's how the initial down payment was formulated and the rest was the recourse obligation that was spelled out in the acquisition agreement.

That was terms that required the certain percentage of the sales proceeds of the book to be applied against the reduction of the debt. It became due in twelve years and ultimately there was an interest rate of nine percent.

I asked him if there were any kind of secret deals or any understanding that would defer or postpone or eliminate or make it not necessary to pay that obligation?

He said, no, none. I am on the hook.

Q Were you given any financial information about Mr. Cohen's company?

A Yes. I asked for and received a certified financial statement prepared by certified public accountants for

particular period, 12/31/82, turned out to be in excess of one million dollars. And there were several hundred thousands of the books that were sold for that particular partnership.

Then, in addition to that I reinterviewed all the individuals again and I went into a little deeper interview.

For example, in Paul Belloff's case I said specifically to him, Paul, had you ever participated in any of the negotiations for the purchase of a book?

He said yes.

On one occasion I made a trip out west with Irving and we visited Price Stern Sloan. And I didn't participate but sat in and listened to the conversation. And to me it was tooth and nail before they came to an understanding as to what Price Stern Sloan would take for this book and what Irving was willing to pay for it and what the down payment would be and so on.

So, I was happy to hear that because that was another confirmation to me of the fact that these books were negotiated individually.

Of course, the prices varied slightly from up to 75,000 to up to two million dollars for a book.

Another point which was significant to me was another corporation, Universal, was assuming the obligations as a lessor. So, I asked Irving about that. And he said, look, the 1981 program was a lessor corporation with ten million capital,

Charge of the Court

Presumptions are deductions or conclusions which the law requires the jury to make and prevails unless overcome or outweighed by evidence to the contrary.

Now, the Rules of Evidence ordinarily do not permit witnesses to testify as to opinions or conclusions. An exception to this rule exists as to those whom we call "expert witnesses". Witnesses who, by education and experience, have become expert in some art, science, profession or calling, may state an opinion as to relevant and material matters in which they profess to be expert, and may also state their reasons for the opinion.

You should consider each expert opinion received in evidence in this case, and give it such weight as you may think it deserves. If you should decide that the opinion of an expert is not based upon sufficient education and experience, or upon sufficient facts, or if you should conclude that the reasons given in support of the opinion are not sound, you may reject the opinion entirely.

You as jurors are the sole judges of the credibility of the witnesses and the weight their testimony deserves. Ordinarily, it is assumed that a witness will speak the truth. But this assumption may be dispelled by the appearance and conduct of the witness, or by the manner in which the witness testifies, or by the character of the testimony given, or by evidence to the contrary of the testimony given.

APPENDIX I

EISENBERG HONIG & FOGLER
Attorneys at Law
270 Madison Avenue
New York, New York 10016
(212) 683-9360
Cable: Levehon New York
TELEX: 129178

Tax Counsel
Irwin S. Meyer
Emil Sebetic

Counsel
David S. Brooks
Alan Asher*
*Member N.Y.
and N.J. Bar

April 18, 1983

Irving Cohen, President
Universal Publishing Resources, Ltd.
95-25 Queens Boulevard
Rego Park, New York 11374

Dear Mr. Cohen:

This will confirm our understanding whereby Universal Publishing Resources, Ltd. ("Universal") will retain our firm, and we will undertake, to defend any challenge to the contemplated tax consequences of the pass throught of the investment tax credit by Universal to certain limited partnerships formed for the purpose of leasing from Universal certain tangible personal property used to print books. Universal intends to agree, as authorized by § 48(d) of the Internal Revenue Code, to elect to treat the lessee-partnership as having purchased such properties for the purpose of the credit allowed by § 38 of the Code and to make a general election for this purpose in accordance with the requirements of the Regulation of the Internal Revenue Service as set forth in § 1.48-4(g).

Our representation of Universal and/or the lessee-partnership shall be before the Internal Revenue Service, or any branch or division thereof, and, if necessary, before the United States Tax Court, the United States District Court and the United States Court of Appeals. All of the fees, disbursements and other expenses to be incurred in connection with any such defense and represention shall be at Universal's sole cost and expense.

If the foregoing is in accordance with your understanding, would you please acknowledge same by signing and returning a copy of this letter.

Very truly yours,

/s/ EISENBERG HONIG & FOGLER
EISENBERG HONIG & FOGLER

ACKNOWLEDGED AND AGREED:

UNIVERSAL PUBLISHING RESOURCES, LTD.

By: /s/ IRVING COHEN
Irving Cohen, President

APPRAISERS

Barrister Equipment Associates has retained a number of professionals to appraise the fair market values of the properties it is leasing and to provide an evaluation of the reasonableness of attaining the profit objectives of the partnership. The general partners have already received verbal approval to proceed with these transactions from their appraisers, and will obtain their written confirmations prior to the closing. Two appraisals per each property are in preparation. A brief summary of the qualifications of several of these appraisers appears below:

I - LITERARY PROPERTIES

Appraiser #1

James A. Bryans has been involved in the publishing industry for 28 years. He has been a literary agent with Scott Meredith, one of the largest and most important organizations in the industry, and for ten years, he was vice-president and editor-in-chief of Popular Library (CBS). At Popular Library he published TO KILL A MOCKINGBIRD, one of the all-time bestsellers in the mass-market field, with upwards of 12,000,000 copies sold to date, and WEBSTER'S NEW WORLD DICTIONARY (paperback edition), the top selling of all paperback dictionaries, with more than 10,000,000 copies sold.

He was for more than four years vice-president and editor-in-chief of Bernard Geis Associates, publisher of VALLEY OF THE DOLLS, SEX AND THE SINGLE GIRL, and numerous other books which sold in excess of one million copies. He was additionally responsible for the editorial development of LORETTA LYNN: COAL MINER'S DAUGHTER, a major bestseller both in hardcover and paperback.

Appraiser #2

George Ernsberger has had vast experiences at both the publishing and retail sales levels of the industry. From 1966 to 1971, he was senior editor at Avon Books, a major paperback publisher responsible for the release of numerous bestsellers, where he additionally introduced to the marketplace the prototype novels of what are the most powerful fiction categories – women's historical romantic adventures. Amongst Avon's bestsellers with which he was associated were novels by Allen Drury, Elia Kazan, Thornton Wilder, Isaac Asimov; and such non-fiction as INSIDE THE THIRD REICH, THE GREEN BERETS, and I'M OK–YOU'RE OK.

During the years 1971 to 1975, Ernsberger served as both vice-president and editor-in-chief of Berkley Publishing Company, as well as an editor of G.P. Putnam's Sons, Berkley's parent corporation. Bestsellers with which he was particulary associated at the time include: PLAIN SPEAKING, THE FIRST DEADLY SIN, and THE TAKING OF PELHAM 1-2-3.

Appraiser #3
Charles Byrne has over 30 years of experience in the book publishing industry. Shortly after World War II, he went to work for Avon Books and in a few years became editor-in-chief and later a vice-president of the company. In 1954 he left Avon and started Berkley Books with a partner. He was editor-in-chief of this book line and later took over as president of the company. During the course of his publishing career, he has published and edited books by authors as diverse as Bob Considine, Erskine Caldwell, Senator Eugene McCarthy and Harold Robbins.

II – COMPUTER SOFTWARE

Since the computer software industry is in its formative stages, the general partners relied upon the market analyses prepared for their Lessor by BOOZ-ALLEN and HAMILTON, Inc. together with other reports and information which they had reviewed themselves; i.e., "Personal Computer Educational Software Market Report" prepared by Future Computing, Inc. 12/82, articles appearing in "Business Week," "Psychology Today," The New York Times, The Wall Street Journal, etc. In addition, the general partners have consulted with two professionals who have already achieved an expertise in the home computer software market to assist them in evaluating bothe the quality of the partnership's software and its distribution commitments in an effort to more clearly approximate the economic feasibility of this venture. The background of one of these professionals appears below:

William A. Wells has been involved with computers and the computing industry since 1964. During the early years, he worked for both ITT and IBM in London before serving as chief executive officer for a leading British software and facilities management company specializing in IBM mini- and micro-computers. Since 1972, he has been working in the United States, and is currently President of Associates in Information Technology, Ltd., which specializes in product and market evaluation as well as in locating opportunities in the computer industry. In 1977 he

was appointed Vice-Chairman of the International Marketing Committee of the Computing Services Association, and more recently, he has been retained by the British government to analyze computer export activities throughout America and the Middle Ease. As a direct result of these activities, British companies have increased their sales of software by over $40 million in 1982.

GRM ASSOCIATES, INC.
290 WEST END AVENUE
NEW YORK, NEW YORK 10023
(212) 874-5964

July 20, 1989

Office of Speical Litigation
U.S. Department of Justice
P.O. Box 7238, Ben Franklin Station
Washington, DC 20044

Gentlemen:

This appraiser has been requested to render an opinion, as of the date of acquisition, as to the Fair Market Value of the Book Properties and Publications Rights to WINDHAVEN'S DESTINY by Marie deJoulet, which were aquired by Universal Publishing Resources, Ltd., on May 10, 1983.

For the purposes of this appraisal, the following should be noted:

Universal acquired the physical properties (Book Properties) to produce paper and hardcovered editions of the Work, with exclusive rights to worldwide publication in the English language for the term of copyright and any extensions, subject to the publisher's performance obligations to the Author.

According to a schedule attached to the contract, what Universal was specifically acquiring was engraved plates and/or lithographic (offset) films of either 16 or 32-page signatures of the text and other pages of the book, four-color processed engraved lithographic films embodying the front-cover artwork for the book; and four-color processed engraved lithographic film for the spine and back-cover artwork for the book. No original art is included.

Thus it is not precisely clear as to whether or not Universal acquired plates or the films from which plates can be made for printing purposes, so far as the book text is concerned. The properties for the cover (or jacket) are more clearly delineated as being films only, from which plates must be made in order to print.

MATERIALS EXAMINED

1. A copy of the August, 1983, edition of the book.

2. A copy of the acquisition agreement between Universal Publishing Resources, Ltd., and Pinnacle Books, Inc.

THE BOOK

PHYSICAL DESCRIPTION

This 4⅛-by-6⅞-inch mass-market paperback volume contains 440 pages, plus eight pages of front matter. The book is perfect bound (glued) with a full-color laminated cover.

That cover has a painting of a man and a woman embracing, against a backdrop of various scenes from the book, the title and the author's name, and a tag line that says that over nine million copies of the books in this series have been sold. It also has the American and Canadian ISBN suffixes, the publisher's name and logo, and an indication of its American price—$3.75.

The spine carries the title and author's names, the ISBN suffixes again, and the publishers' name and logo, together with the information that this is a novel.

The copyright page gives 1983 credit for this to Book Creations, Inc., and indicates that this is an original book, never before published. It also indicates that the first printing was August, 1983. The book was produced by Book Creations, Inc., of which Lyle Kenyon Engel was Executive Producer. The American and Canadian ISBNs are listed, together with a credit to the cover artist, the information that it was printed in the United States of America, and the publisher's name and address.

The text of the book is printed on 40-pound groundwood paper, with readable type, although the pages tend to look crowded.

THE CONTENTS

This twelfth book in the Windhaven Series continues the story of the Bouchard family, of French origin, who settled in Alabama in the 18th

century. Now it is the post-Civil War era. The family is scattered, there is trouble in Alabama, and the widow of the last head of the family has remarried and must cope with the problems of raising her children as well as keeping the far-flung family together. Some are out West, some are down South, some are in the East, etc.

The book is replete with plots and subplots, family intrigue, misunderstandings, some violence, some jealousy, etc. In other words, it covers every element that these romance novels usually do in an attempt to involve the reader in the ongoing story of these people, none of whom sound real. They are all bigger than life, and the cast of characters is enormous. By this time, the family is very large, their names are almost all foreign ones (French, Spanish, Indian, etc.) and it is almost impossible to keep the characters straight without looking at the genealogy chart that is at the beginning of the book.

COMMENTS

Although this series has apparently had sales success, it would seem that there is a limit to how much you can drag on the story of a family like this. As it moves farther and farther from its origins, it is harder and harder for readers to relate to the over-all story–and more and more necessary to keep repeating the original tales. Thus, it becomes less and less interesting.

In addition, the book is not written well enough to make a reader want to wait for the next episode in the story of this family. It is this appraiser's opinion that the books have some series continuity, but that, ultimately, they are sold as one-up novels and that, if anything, the series does not add to saleability.

This appraiser also questions the accuracy of the statement that over nine million copies have been sold of the previous eleven books in the series, which would have made an average of 818,000 each. That is so much above industry average for books like this as to be incredible. 200,000 copies per book would have been a good average and is probably closer to the truth.

In any event, this sort of relatively "clean" novel will be carried by public libraries, and general trade bookstores, and other places where women's generational romances are sold. And there is a good chance, that as this

series seems to be winding down, the sales average for this title would be lower than that for the rest of the series. It is probable that it is the first one or two titles in the series that garnered the most market and that it has been slipping ever since.

ACQUISITION AGREEMENT

This May 10, 1983, contract is between Pinnacle Books, Inc., of 2029 Century Park East, Los Angeles, CA (Publisher), and Universal Publishing Resources, Ltd., a Nevada corporation with offices at 333 Rancho Drive, Las Vegas, Nevada 89106 (Purchaser). It is a lengthy document with a number of clauses concerning the rights of the purchaser, the rights retained by the Seller, a delineation of exactly wht is being transferred, and various stipulations regarding payment. No attempt will be made herein to analyze each of these items.

In addition to the brief description of the assets being acquired by Universal aready set forth at the beginning of this appraisal, it should be noted that the copyright is not transferred, nor does Universal acquire the right to exploit subsidiary rights.

APPRAISER'S EVALUATION

"Fair Market Value" has been defined as the price at which property changes hands between a willing seller and willing buyer, neither of whom is obligated either to sell or to buy, and both of whom have knowledge of the relevant facts in the matter.

VALUATION METHODOLOGY

In the valuation of any property, there are three basic factors that may come into play, either singly, or in combinations of two or more of each. There may also be other special circumstances for individual valuations, but for the purposes of this report, they will be disregarded. The basic factors are:

1. Income: An estimate of potential gross sales revenue of the property at an indicated price, reduced by known costs of production and marketing, and further discounted for appropriate risk factors.

However, it should be noted that this is far from being a risk-free

acquisition. After all, the purchaser has no experience as a book publisher or packager, and is totally dependent on the efforts of others to manufacture and market his acquisition. For the sake of simplicity, however, and in order to avoid a lengthy discussion of calculation of risk factors, no discount for the obvious risks is employed.

There is an additional valid discount factor – that of reducing total estimated dollar income to present value as of the date of Universal's acquisition. Again, it is being disregarded for the purposes of simplicity in this report.

2. Cost: In the case of the book in question, this would, in turn, be based not only on the charges for manufacturing (paper, printing, binding, cover dies, platemaking, etc.), but should have an additional factor related to the cost of acquisition by Universal. This is, however, unknown to this appraiser at the present time, so cannot be included.

In turn, however, such factors as whether or not the book was in the public domain (that is, did the Seller to Universal have to pay an author to acquire the rights), or whether or not the type and other design factors already existed so that only replication for Universal was needed, not new creation, would be bases for the price to Universal.

In addition, the following should be noted:

a. The purchaser of the Book Properties, Universal, would be obligated to pay for the costs of paper, printing, and binding, plus platemaking where necessary, and binder's dies, in advance of production. This additional preliminary cost is not set out as a separate item for which money-discount values are estimated in this report, although it would be valid to do so.

b. Likewise the costs of reprints are not to set out in this report, but should be noted as being factors in the over-all economics of the book's publication. That is, even though the plates might have been purchased by Universal, they are not reusable, and would have to be remade from the film each time the book went back to press. This can be a considerable expense, especially if the reprints are for small quantities of books; the plate costs, therefore, have to be amortized over a small printing, thus increasing the unit cost of each volume printed. And, of course, small reprintings also cost more because the advantages of economies of scale are lost therein.

For the purpose of this report, these two elements will be disregarded in estimating production costs, but the reader should bear them in mind as existing.

3. Market: The best product in the world depends on the demand for it–or the ability of its owner or distributor to create that demand. For books, some of the elements that influence demand are:

Competition from other books on the same subject or from other editions of the same book or similar works by the same author

Timeliness (i.e., subject matter and how it is handled)

Importance of the author

Popularity of the genre at the time of publication

Special-interest attraction

Skill of the publisher or distributor in marketing the work

Production quality; i.e., attractiveness and appropriateness of packaging

Price

The valuation of this acquisition is based on these factors, as appropriate, and on the assumption of the most favorable conditions that could have existed at purchase date, given the history of the book until that time and any other relevant information that could have been obtained by the purchaser, Universal:

1. The distributor was unknown, but an average 50-percent discount off the list price, excluding distribution fee, is assumed.

2. In trade publishing, the maximum sale of a book usually occurs within one year after publication, and often as rapidly as within the first few months after its publication. After that, if the book has potential for longer life, it will settle down to fewer annual sales on a more-or-less regular basis, on which the publisher can count, and it goes into what is called the backlist. Some books have indefinite backlist lives because they

are universal in appeal and new generations of readers are attracted to them. Others, however either because they go out of style (or their authors do) or because their contents become dated, or because competing works push them out of the market, do not last indefinitely and for a number or reasons, their publishers find that it is not worth while to keep them in print. Thus, even books that are still selling, albeit slowly, may be dropped from the backlist because:

a. Their very slow sales make it uneconomic to keep them in the computer, in the catalog, and to give them warehouse space, all of which are costly functions.

b. If their inventory drops to a reprint level (i.e., if the go out of stock, which can happen even with slow sellers), their sales may not warrant a reprint. That is, the costs of reprinting cannot be recovered within an economic time frame, or the costs of reprinting the small quantities that can be expected to sell are so high that the list prices would have to be raised to a level that would make them unmarketable.

The valuation that follows presumes that the distributor or services contractor for this title functions at maximum efficiency under the most favorable market conditions prevailing. It does not consider the very real possibility that for one reason or another this entity will not be able to fulfill its marketing obligations during the anticipated sales life of the title. That is, it may go out of business, it may merge and the new setup eliminates certain types of books and/or activities, it may suffer business reverses that cause it to be less efficient as a marketer, and so on.

It is estimated that under the most favorable sales conditions, with the most efficient and effective distribution possible, sales of this title will not exceed 100,000 copies within three years after publication. After this time, sales would be so negligible as not to warrant their being a factor in potential income.

3. No publisher prints exactly the number of copies it anticipates selling. In fact, all printers include an overage or underage factor, since it is almost impossible to produce an exactly even number of copies desired. Remembering, however, that we are dealing with an idealized situation, on a first printing it is customary to allow at least a 10-percent overage for a variety of in-house purposes, which include:

Author copies

Salesmen's copies

Copyright-registration copies

In-house reference copies, including maintaining an out-of-print library to use for permissions, possible future reprint bases, etc.

Review copies

Shrinkage–there are always some damaged or unsalable copies, and there must also be an allowance for pilferage, which occurs even with the most arcane books. And the better and more salable the book the higher percentage of shrinkage.

Mass-market paperback volumes are not handled the same way as hard-cover books are for return purposes. Most books are sold on a consignment basis and hardcovers are sent back. However, paperbacks are handled differently. Their covers are stripped, and the covers are sent back for credit. The books themselves are supposed to be shredded, but frequently are not, and are sold at reduced rates, thus creating competition for the publisher's regular volumes and cheating authors and publishers of proper income. This is an industry-wide problem. Because returns of mass-market paperbacks can be as high as seventy or eighty percent, publishers must always print a considerably larger number of copies than the ones they expect to sell. Sixty-five percent is considered to be a good sell-through for a paperback, but in order to be conservative, this appraiser estimates that fifty percent would be a better sell-through for this book

4. Thus, for this title, an additional 100,000 copies of the book should be ordered. This makes a total of 200,000 copies to be manufactured, of which 100,000 would not be income-producing.

5. If Universal acquired the plates for printing, as differentiated from acquisition of the lithograph films only, these plates costs are not included in the estimate that follows. If, however, Universal acquired films only, there would have been additional costs. These, however have been disregarded for the purposes of this appraisal, and plate acquisition has been assumed.

But the cost of plating the cover film is definitely one that must be assigned to these charges, as Universal did not purchase these plates. The plateing cost for the cover film would have been an additional item in the over-all cost. The cost of the binder's die that was needed for the embossing on the cover, which is modest, and would be part of Universal's charges, as this was not purchased.

6. As of the date of production of this book, the charges for printing 200,000 copies of this title in the format seen by this appraiser would be $.50 per copy.

7. The anticipated income has been given the most favorable treatment by not discounting it for either risk or time. Therefore, these estimates are most favorable to Universal Publishing Resources, Ltd.

INCOME CALCUATIONS

The income calculations that follow are based not only on the estimated sales at the indicated list prices, with the sales-discount factor of 50-percent, excluding distribution fee, which has already been noted in this report, but also consider three other elements not previously discussed herein:

1. Distribution expenses, i.e., the cost of selling the books (salesmen, warehousing, etc.), which are calcuated at an average of nine percent (9%) of the gross income.

2. Overhead, which would be borne by any publisher, including Universal, at an average of ten percent (10%) of the net after distribution. This reflects costs from the point of production at which the Book Properties were purchased.

3. Royalties. Although the acquisition contract is specific in stating that these are the Publisher's (i.e., Seller's) responsibility, in actual fact, it is only the advance on royalties paid prior to Universal's acquisition that is not its charge. This is subsumed in the purchase price that Universal paid for the Book Properties. However, at the point at which this royalty advance is amortized (i.e., the point at which the book's royalty earnings under the contract with the author or other entity that licensed the book rights exceed this royalty advance), the royalties become an obligation of Universal through the Services or Distribution contract

to produce, market, and otherwise manage the Book Properties and attendant rights acquired by Universal.

The actual calculations follow.

1. Number of books sold	100,000
2. Retail sales price of books	$3.75
3. Revenue (#1 x #2)	$375,000
4. Percentage of revenue received by publisher (50% discount)	x.5
5. Gross income (one half of #3)	$187,500
6. Minus Distribution Fee (9% of #3)	($33,750)
7. Net to publisher after distribution fee (#5 - #6)	$153,750
8. Minus Overhead (10% of #7)	($15,375)
9. Net after overhead (#7 - #8)	$138,375
10. Number of books printed	200,000
11. Cost of ppb per book	$.50
12. Total cost of ppb (#10 x #11)	$100,000
13. Royalty (if applicable)	N/A
14. Total cost of production (#12 / #13)	($100,000)
15. Net Income (#9-#14)	$38,375

Therefore it is this appraiser's opinion that the Fair Market Value, as defined on page 3 of this report, of the Book Properties and Publication Rights acquired by Universal Publishing Resources, Ltd., on May 10,

1983, for WINDHAVEN'S DESTINY by Marie deJoulet is no greater than:

$38,375 as of the date of acquisition

I prepared this report by myself, and my credentials are set forth in the enclosed biographical summary.

Very truly yours,

/s/ GLORIA R. MOSESSON
GLORIA R. MOSESSON

enc.

PRODUCT BESERKER RAIDS (Software and Player's Manual)

MARKET SEGMENT Adult computer games

MARKET COMMITMENT

Packaging Note: Generic design of container saves jacket design costs but lowers retail potential. (See Packaging Note on page 2 of Evaluation Background.)

MAINTENANCE REQUIREMENT Clear competitive need for regular upgrades of graphics plus technical correlations with new and/or improved computers.

LIMITATIONS

Technique Although there are 10 different games, the manipulative technique is basically the same. It would be more accurate to say that there are 10 variations on the same game. The technique is primitive and will seem more so as new products appear in the market. The program will have to be first upgraded and then be made compatible with changes in the computers on which it is to play.

Complexity Level The game requires considerable reading and computation.

Competition

Similar Product Market already contained oversupply of computer games at the time of publication.

"User Friendly" Complicated instructions.

Revision Likelihood High because of technical change.

Projected Usefull Life Short in present form because of competitive factors and technical changes.

8754638/A

BOOKS APPRAISED BY CHARLES SELDEN

SERIES/ BOOK	TITLE	SELDEN APPRAISAL VALUE
115/01M	ALPHABET GAME	0
115/02M	WINGS OUT OF SHADOW	0
115/03	PROFIT & LOSS & CASH FLOW	0
116/01M	CHEMISTRY	0
116/02M	BERSERKER RAIDS	1,656
116/10	BUSINESS SOFTWARE FOR IBM/PC	0
117/01M	GEOMETRY G WIZ	426
117/12	PROGRAMMING LANGUAGES	0
121/01M	AMER. HISTORY DECADES GAME #1	0
121/02M	STARBALL	726
121/39	PERSONAL COMPUTER IN ADVERTISING	0
123/01	WORD ELEMENTS: PREFIXES I	0
123/02	ADVENTURES WITH PC JR.	726
126/01	AMER. HISTORY DECADES GAMES #2	0
126/02	FRENCH I	2,400
126/19	COMPUTERS IN CRISIS	0
126/34	THE IBM/PC AND 1-2-3	0

Supreme Court, U.S.
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(2)

No. 93-271

In the Supreme Court of the United States

OCTOBER TERM, 1993

MADISON LIBRARY, INC., ET AL., PETITIONERS

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

DREW S. DAYS, III
Solicitor General

MICHAEL L. PAUP
Acting Assistant Attorney General

JONATHAN S. COHEN
STEVEN W. PARKS
Attorneys

Department of Justice
Washington, D.C. 20530
(202) 514-2217

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16 pp

QUESTION PRESENTED

Whether, in upholding the jury's finding that petitioners made gross valuation overstatements within the meaning of 26 U.S.C. 6700 in connection with their promotion of a tax shelter, the court of appeals erred in holding (i) that the purchase price paid for the property by the principal promoter of the tax shelter was not conclusive as to the fair market value of the property and (ii) that the district court did not abuse its discretion in admitting appraisal evidence to establish the fair market value of the property.

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BRIEF FOR THE UNITED STATES IN OPPOSITION

OPINIONS BELOW

The opinion of the court of appeals (Pet. App. A1-A26) is reported at 989 F.2d 1290. The opinion of the district court is reported at 766 F. Supp. 1248.

JURISDICTION

The judgment of the court of appeals was entered on March 22, 1993. The petition for rehearing was denied on May 20, 1993 (Pet. App. A29). The petition for a writ of certiorari was filed on August 17, 1993. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. This case involves the imposition of a penalty under Section 6700 of the Internal Revenue Code for the promotion of an abusive tax shelter. The tax shelter involved the purchase and subsequent leasing of rights to market books and computer software. Those rights, together with the metallic plates, lithographic films, and other equipment used in printing the books and reproducing the software, are referred to as the "properties" (Pet. App. A6). Petitioners Geoffrey Townsend, Ltd. (Townsend) and Universal Publishing Resources, Ltd. (Universal), both of which were wholly owned subsidiaries of petitioner Madison Library, Inc., purchased the properties from publishing companies during 1982 and 1983 (*id.* at A5-A6). Irving Cohen, who was president of Townsend, Universal and Madison Library, negotiated the purchases on behalf of the corporations (*ibid.*).[1]

The properties were all purchased under the same format. Townsend and Universal made small cash down payments and executed promissory notes bearing interest at nine percent for the remainder of the purchase prices (Pet. App. A6). Except to the extent that net revenues were realized from retail sales of the books or software, no payments of principal or interest on the notes were due for 12 years. At the end of the twelfth year, Townsend and Universal were obligated to make balloon payments of the remaining unpaid interest and principal (*ibid.*).

The linchpin of petitioners' scheme was establishing highly inflated purchase prices for the properties in order to maximize the hoped-for tax benefits. The purchase prices were determined for each property by mul-

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[1] The stock of Madison Library, Inc., was held in trust for the benefit of the children of Irving Cohen (Pet. App. A5).

tiplying the projected number of copies of the books or computer programs to be produced by a percentage of the expected retail sales price of those items (Pet. App. A6). Applying this formula, Townsend and Universal purchased 3774 properties during 1982 and 1983 at an average price that exceeded $500,000 per property, thereby ostensibly incurring a combined total debt that exceeded $1.9 billion (*id.* at A7).

2. Townsend and Universal leased interests in the properties to 95 limited partnerships. Petitioner Barrister Associates, a New York general partnership in which petitioners Robert Gold and Paul Belloff were the sole partners, was the general partner for each of the 95 limited partnerships (Pet. App. A5, A7). Under the lease agreements, Townsend and Universal agreed to pass through to the limited partnerships investment tax credits of from eight to ten percent of the fair market value of each property (*id.* at A7-A8). See 26 U.S.C. 38, 46(a), 48(d).[2]

Interests in the limited partnerships were marketed to the public by petitioner Chadwick Investment Co., a Subchapter S corporation owned by Gold, Belloff and an unrelated party (Pet. App. A5, A9). Petitioners represented that the fair market value of each property was equal to the purchase price Townsend and Universal had negotiated. A brochure used to market one of the limited partnerships explained that a limited partner in the 50% tax bracket who invested $50,000 would obtain investment tax credits and income tax deductions that would generate tax savings of $75,600 (*id.* at A8).

None of the limited partnerships printed, manufactured, or distributed the books or software. Entities

[2] The investment tax credit was generally repealed for property placed in service after December 31, 1985. Tax Reform Act of 1986, Pub. L. No. 99-514, § 211(a), 100 Stat. 2166.

known as "service contractors" were retained to perform those tasks and to bear the related costs (Pet. App. A8). The service contractors were ordinarily affiliated with the publisher who had sold the property to petitioners (*ibid.*). In return for their services, the contractors collected fees from the limited partnerships based on a percentage of the sales price of each book or software item actually sold (*id.* at A9).[3] Under the terms of the purchase and service agreements, virtually all net revenues to be realized from sales flowed to the publishers, either directly or through payments to the service contractors (*id.* at A16).

3. Section 6700 of the Code imposes a penalty on persons who engage in the promotion of abusive tax shelters. The penalty applies to "[a]ny person" who "organizes (or assists in the organization of)" a partnership or other entity (i) that makes statements with respect to the allowability of tax benefits that the person knows or has reason to know are false or fraudulent or (ii) that makes "a gross valuation overstatement as to any material matter" (26 U.S.C. 6700(a)). The term "gross valuation overstatement" is defined to mean an overstatement in the value of a property that "exceeds 200 percent of the amount determined to be the correct valuation" (26 U.S.C. 6700(b)(1)(A)). The amount of the penalty at the time of petitioners' activities was the greater of $1,000 or 10 percent of the gross income derived (or to be derived) by such person from such activity. See 26 U.S.C. 6700(a) (1982); Pet. App. A12-A13, A17.

[3] The service agreements specified an anticipated initial printing, and minimum additional printings, that established the maximum number of copies the service contractor was required to print. Although the service agreements were negotiated by the same parties who negotiated the prices of the properties, the number of copies in these agreements bore no relation to the number of copies used in determining the properties' prices (Pet. App. A9).

The Internal Revenue Service determined that petitioners made false and fraudulent statements and gross valuation overstatements subject to penalty under Section 6700. Petitioners paid a portion of the penalties assessed against them and instituted suits for refund of the amounts paid. See 26 U.S.C. 6703. The government filed counterclaims for the unpaid balance of the penalties (Pet. App. A9-A10).

4. The issue of liability for the penalties was tried to a jury. Six of the limited partnerships were chosen by the parties as representative of all of the partnerships for purposes of the trial (Pet. App. A11). The evidence admitted at trial included documentary evidence establishing the nature and details of the various transactions for each property and appraisal reports and testimony offered by both petitioners and respondent. The district court rejected petitioners' contention that the appraisal evidence offered by the government was too subjective to be relevant and admissible (*id.* at A16-A17). The government's appraisal witnesses valued the properties at approximately 2.5% of the prices to which Townsend and Universal had agreed.[4]

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[4] The total fair market value of the properties claimed by petitioners for the purpose of computing the investment tax credits was $143,691,000. The government's appraisal witnesses testified that the fair market value of those properties was $3,612,648 (C.A. App. 923-934). Petitioners' appraisal witness did not independently appraise the properties. Instead, he testified that the prices paid for the properties could have been arrived at by the parties by negotiation (*id.* at 1905).

The government also presented expert financial analyses and testimony concerning the profit potential of the books in question based on (i) the actual sales experience from 28 limited partnerships involved in a related program (C.A. App. 1812-1819); (ii) industry average sales (*id.* at 1819-1826, 1834-1835); and (iii) the assumption that one book in each partnership would achieve sales equal to those of the very best selling book in the industry in the

The district court instructed the jury that the fair market value of a property was "the price at which the property would change hands between a willing buyer and willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of the relevant facts" (C.A. App. 79). The court further instructed the jury to accord expert opinion "such weight as you may think it deserves," noting that, if the opinion was not based upon "sufficient facts, or if you should conclude that the reasons given in support of the opinion are not sound, you may reject the opinion entirely" (*id.* at 73). The court also instructed the jury that, "[u]nless the [government] has established that Universal and Townsend consciously inflated the purchase prices of the properties under the terms of their acquisition agreements, you should find that the purchase price they negotiated is [the] fair market value of the book properties" (*id.* at 81). The jury was further instructed that the value must be determined based on the facts known at the time the transactions occurred, and that "Monday morning quarterbacking has no place in this valuation process" (*ibid.*).

The jury returned a verdict finding that petitioners "did not purchase the properties in the six test partnerships in good faith, bona fide arm's length transactions" and had made gross valuation overstatements within the meaning of Section 6700 (C.A. App. 175-176). The jury found a total of 17 false or fraudulent statements that

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previous year (*id.* at 1829-1830). Those analyses showed that the stated purchase prices of the properties were grossly in excess of the amounts that could be realized from sales. There was also evidence that books comparable to those for which Townsend and Universal negotiated six- to seven-figure prices often could have been produced on a for-hire basis for a few thousand dollars (*id.* at 1303, 1306-1307, 1312, 1315, 1322, 1327, 1932-1937, 1941-1942, 1944-1946).

were subject to penalty under the statute (*id.* at 134-192). Petitioners filed motions for judgments notwithstanding the verdicts or for new trials, which the district court denied (Pet. App. A33).[5]

5. The court of appeals upheld the jury's finding that petitioners had made gross valuation overstatements and affirmed the judgment of liability under Section 6700. The court stated that, although a price arrived at through arm's length negotiations is "usually the most reliable evidence of fair market value," that price is not conclusive when, for example, "a transaction is based upon 'peculiar circumstances' which influence the purchaser to agree to a price in excess of the property's fair market value" (Pet. App. A14, quoting *Bixby* v. *Commissioner*, 58 T.C. 757, 776 (1972)). The court concluded that the government's appraisal evidence was not inadmissible simply because there was also evidence of arm's length bargaining in this case: evidence of the negotiated prices and the expert appraisal evidence were both relevant in determining the properties' values (Pet. App. A14-A15).

Reviewing "the totality of the evidence offered by the government, including the testimony and reports of the appraisers and the evidence concerning the various relationships and transactions" (Pet. App. A15), the court noted that there was a substantial basis for the jury to find that petitioners' transactions were not at arm's length. The evidence reflected that petitioners' transactions "were based on the sort of 'peculiar circumstances' that defeat any presumption that the purchase prices re-

[5] Pursuant to an agreement of the parties, the amount of the penalties was determined by the district court, rather than by the jury. The government filed a cross-appeal on two computational issues resolved by the district court (Pet. App. A12, A24-A26). Neither of the computational issues is involved at this stage of the case.

flected the fair market values of each of the Properties" (*id.* at A16). The "facts concerning this tax shelter, and inferences to be drawn from them," indicated that petitioners "had strong incentives to agree to inflated prices in order to increase the tax benefits available to the limited partnerships" (*id.* at A15). Moreover, the excessive prices did not create "genuine risk of loss beyond the downpayments" because the publishers could look only to the corporate assets of Townsend and Universal at the end of the twelve-year term for collection, and could "easily find that by then the corporate cupboards would be bare" (*ibid.*). "Once the transactions were so understood by the jury," the court held, "its conclusion that [Townsend and Universal] wanted to inflate the size of the promissory obligations—the larger the obligation, the greater the resulting investment tax credit—was inexorable" (*id.* at A16).

The court also rejected petitioners' contention that the government's appraisal evidence was "too subjective to be admissible" (Pet. App. A16). The government's appraisers were "qualified as experts," and "their valuations were grounded on their experience in the publishing industry and on objective factors such as the potential market for the book or software, the reputation of the author, and competition from other works" (*id.* at A16-A17).

In view of its decision that petitioners had made gross valuation overstatements, the court found it unnecessary to review the jury's further findings that petitioners had made false and fraudulent statements (Pet. App. A13).[6]

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[6] The court of appeals held in favor of the government on one of the two computational issues raised by the government in its cross-appeal. See note 5, *supra*.

ARGUMENT

The jury had an ample evidentiary basis to find that petitioners made gross valuation overstatements within the meaning of Section 6700 of the Internal Revenue Code. The decision of the court of appeals does not conflict with any decision of this Court or any other court of appeals. Further review is therefore not warranted.

1. The fair market value of a property is generally defined as the price at which it would change hands between a willing buyer and a willing seller, neither being under compulsion to buy or sell, and both having reasonable knowledge of the relevant facts. *United States* v. *Cartwright*, 411 U.S. 546, 551 (1973). Although a price reached in arm's length negotiations between a buyer and seller is often reliable evidence of fair market value, the agreed price is not necessarily conclusive of the correct fair market value. This is especially so when special circumstances may have influenced the purchaser to agree to an excessive price. *Bryant* v. *Commissioner*, 790 F.2d 1463, 1465-1466 (9th Cir. 1986); *Bixby* v. *Commissioner*, 58 T.C. 757, 776 (1972).

In the present case, the jury was entitled to find that, in negotiating the prices of the properties on behalf of Townsend and Universal, Irving Cohen consciously agreed to grossly excessive prices (largely on long-term credit) in the hope of generating artificially large investment tax credits. By agreeing to prices far in excess of the fair market value of the properties, the partners of the limited partnerships that leased the properties hoped to realize inflated tax credits and deductions that would yield tax benefits in excess of their investments even if no books or computer programs were ever sold. The average price of each property exceeded $500,000, a price that assumed enormous sales volumes. The government's appraisal evidence showed that the agreed prices were approximately 40 times greater than

the properties' fair market values. There was also evidence, in many instances, that properties comparable to those purchased by petitioners for six- to seven-figure prices could have been produced on a for-hire basis in the marketplace for a few thousand dollars. See note 4, *supra*. Moreover, since the publishers could look for payment only to the assets (if any) that might remain in Townsend and Universal at the end of the twelve-year terms of the notes, the jury could properly conclude that there was never an intention that the inflated purchase prices would actually be paid (Pet. App. A15). Based on the totality of this evidence, the court of appeals correctly upheld the jury's finding that Townsend and Universal did not purchase the properties in bona fide arm's length transactions and that, in representing that the fair market values of the properties were equal to the prices Universal and Townsend ostensibly agreed to pay, petitioners made gross valuation overstatements within the meaning of Section 6700.

2. Petitioners erroneously assert that the court of appeals held that mere "consideration of tax consequences is sufficient grounds to disregard a negotiated purchase price and to overcome uncontradicted testimony that the bargaining was at arm's length" (Pet. 12). Based on that erroneous assertion, petitioners contend that the decision in this case conflicts with decisions of this and other courts. *E.g.*, *Frank Lyon Co.* v. *United States*, 435 U.S. 561, 580 (1978).

Petitioners' characterization of the court's decision is not correct. The court of appeals held that the jury was entitled to find that Townsend and Universal wanted to inflate the size of the promissory obligation because "the larger the obligation, the greater the resulting investment tax credit" (Pet. App. A16). Petitioners did not merely take potential tax benefits into account in purchasing the properties. They sought to create bogus in-

vestment tax credits by deliberately agreeing to grossly inflated purchase prices that were payable only out of any assets that might remain in Townsend and Universal 12 years later. The decision of the court of appeals simply reflects that when, as in the present case, there are "peculiar circumstances" that may "influence the purchaser to agree to a price in excess of the property's fair market value," the price that the parties negotiate is not necessarily conclusive of the fair market value of the property (*id.* at A14, quoting *Bixby* v. *Commissioner*, 58 T.C. at 776).

3. Petitioners further contend (Pet. 15) that the decision in this case conflicts with the decisions of the Tax Court in *Sheid* v. *Commissioner*, 50 T.C.M. (CCH) 663, 670 n.24 (1985), and *Abramson* v. *Commissioner*, 86 T.C. 360, 372 & n.16 (1986). Petitioners assert that the Tax Court held in those cases that appraisal evidence is not admissible unless there has been an independent demonstration that there was an absence of arm's length bargaining. In *Sheid*, however, the Tax Court held simply that it was "open to question" whether appraisal evidence was relevant where there were "no *special circumstances* present" (50 T.C.M. (CCH) at 670 (emphasis added)). In *Abramson*, the Tax Court similarly concluded that, "there being no *special circumstances* present," it was "open to question whether appraisal testimony has any relevance" (86 T.C. at 372 (emphasis added)). Neither case involved the question whether appraisal evidence is admissible when the purchaser deliberately agreed to a price in excess of the property's fair market value.[7]

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[7] In a similar vein, petitioners assert (Pet. 13-14) that the decision in this case conflicts with decisions in which courts have disapproved of the use of hindsight or the second guessing of a taxpayer's business judgments in determining whether the taxpayer had a genuine profit motive. Petitioners cite (Pet. 13) as an exam-

4. There is no merit to petitioners' assertions that the decision of the court of appeals conflicts with decisions in which the courts have disapproved of purely subjective expert testimony (Pet. 17-19). The district court did not credit petitioners' assertions that the government's appraisal evidence was too subjective to be admissible; and, as the court of appeals observed, "[t]he four government appraisers were qualified as experts, and their valuations were grounded on their experience in the publishing industry and on objective factors such as the potential market for the book or software, the reputation of the author, and competition from other works" (Pet. App. A16-A17). Petitioners' assertion that the appraisal evidence was too subjective to be admitted was thus properly rejected by both courts below. Further review of this factual claim is not warranted. See *Tiffany*

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ple *Cornfeld* v. *Commissioner*, 797 F.2d 1049 (D.C. Cir. 1986), which presented the question whether a taxpayer engaged in an activity (the leasing of aircraft) with the requisite profit motive that would permit him to deduct expenses associated with the activity. In neither *Cornfeld* nor any other case cited by petitioners did the courts hold that appraisal evidence may not be used to show the fair market value of property or that appraisal evidence is not admissible in a case in which the purchaser of property is claimed to have agreed to excessive prices in order to artificially inflate the amount of the investment tax credit to be claimed for the property.

Petitioners also suggest (Pet. 15-16), by quotations from *King* v. *United States*, 545 F.2d 700, 709 (10th Cir. 1976), and *Simon* v. *New Haven Board & Carton Co.*, 393 F. Supp. 139, 145 (D. Conn. 1974), aff'd, 516 F.2d 303 (2d Cir. 1975), that the jury and the court of appeals improperly took into account the actual profitability (or lack thereof) of the properties after their acquisition in determining their fair market value. But evidence of the actual profitability of the properties after their acquisition was excluded at trial and was not considered by the jury or by the court of appeals. See page 6, *supra*.

Fine Arts, Inc. v. *United States*, 469 U.S. 310, 318 n.5 (1985).

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

DREW S. DAYS, III
Solicitor General

MICHAEL L. PAUP
Acting Assistant Attorney General

JONATHAN S. COHEN
STEVEN W. PARKS
Attorneys

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